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Changing the Rules, but not the Goodwill Game: Newark Morning Ledger in the Wake of I.R.C. Section 197

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CHANGING THE RULES, BUT NOT THE GOODWILL GAME: NEWARK MORNING LEDGER IN THE WAKE OF I.R.C. SECTION 197[†]

“To know a thing’s nature is to know the reason why it is.”[†]

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I. Introduction

Goodwill is an elusive concept.¹ Attempts to adequately define it

† The author thanks Professors Jennifer J. S. Brooks and Denise D. Roy for their assistance in the completion of this Comment.

† Aristotle POSTERIOR ANALYTICS, Book II, Chapter 2, *reprinted in*, WALTER KAUFMAN, PHILOSOPHIC CLASSICS, VOLUME 1: THALES TO OCKHAM 295 (2d ed. 1968).

1. The label “goodwill” has numerous and varying meanings, as one court noted: Goodwill sometimes is used to describe the aggregate of all of the intangibles of a business. . . . Since a normal rate of return usually is calculated on tangible assets only, goodwill has been used as a synonym for the return on all the intangibles of a business. In a more restricted sense, goodwill is the expectancy that the old customers will resort to the old place. It is the sum total of all the imponderable qualities that attract customers and bring patronage to the business without contractual compulsion. Another definition equates goodwill with a rate of return on investment which is above

have stymied tax lawyers, scholars, and the Internal Revenue Service, since the advent of the income tax in the United States.² Taxpayers have yearned for a clear definition of goodwill so as to avoid the tax consequences of its label,³ because traditionally, goodwill has been a non-depreciable,⁴ intangible asset.⁵

normal returns in the industry and limits it to the residual intangible asset that generates earnings in excess of a normal return on all other tangible and intangible assets.

Richard S. Miller & Sons, Inc. v. United States, 537 F.2d 446, 450-51 (Ct. Cl. 1976) (citations omitted). See generally Robert J. McDonald, *Goodwill and the Federal Income Tax*, 45 VA. L. REV. 645 (1959); Note, *An Inquiry Into the Nature of Goodwill*, 53 COLUM. L. REV. 660 (1953); Floyd A. Wright, *The Nature And Basis Of Legal Goodwill*, 24 ILL. L. REV. 20 (1929).

2. The Tariff of 1909 permitted corporate depreciation deductions without expressly discriminating between tangible and intangible property. T.D. 1536, 12 Treas. Dec. Int. Rev. 96 (1909) (permitting deductions from gross income for "all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any"); see also *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1674 (1993) (observing that the depreciation deduction has been a part of the federal tax system at least since the passage of the Tariff of 1909, specifically, § 38 Second, 36 Stat. 11, 113). When goodwill was later precluded from the depreciation deduction in 1911, the stage was set for the ensuing years of contests between taxpayer and government. T.D. 1675, 14 Treas. Dec. Int. Rev. 21 (1911) (expressly excluding depreciation deductions for "good will").

3. Prior to the adoption of Internal Revenue Code Section 197, goodwill was a non-depreciable intangible asset. The General Accounting Office ("GAO") noted:

When these conflicts arise, they are caused by the disparity between the tax treatment of (1) goodwill and other nonamortizable intangible assets without determinable useful lives and (2) amortizable intangible assets with taxpayer-determined useful lives. This disparity gives taxpayers an incentive to establish values and useful lives for purchased intangible assets other than goodwill.

UNITED STATES GENERAL ACCOUNTING OFFICE, GAO/GGD-91-88, *Tax Policy: Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets*, 5 (August 1991). The GAO also noted: "[W]e believe that taxpayer's determinations [of a purchased intangible asset's actual value and economic useful life] could be influenced by their tax consequences." *Id.* at 38.

4. Typically, the term "depreciation" refers to the concept of recovering the original capital invested in tangible or capital assets used in a business over the asset's estimated useful life. Martin J. Gregorich, *Amortization of Intangibles: A Reassessment of the Tax Treatment of Purchased Goodwill*, 28 TAX LAW. 251, 252 (1975). The term "amortization" refers to the same concept, except applied to a business' intangible assets. *Id.* at 253. This Comment will follow the statutory and regulatory convention that predominately applies the term "depreciation" to both tangible and intangible property.

5. An intangible asset is property that is "immune to physical forces, . . . and unless limited in duration by statute or contract or so closely linked to a physical asset as to be rendered worthless by its retirement from service, they are unaffected by the mere passage of time." BORIS I. BITTKER & MARTIN J. MCMAHON, JR., *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶ 12.4, at 12-10 (1988 & Cum. Supp. No. 2, 1994). For

Motivated by the desire for deductions, taxpayers have tested the definition of goodwill.⁶ The resulting case history reveals divergent treatment of these controversies.⁷ The Supreme Court, in *Newark Morning Ledger Co. v. United States*,⁸ finally brought unity to the judicial approach to depreciating intangibles and defining goodwill. The Court held that a taxpayer may depreciate an intangible asset, regardless of how much the asset appears to reflect “the expectancy of [goodwill]”⁹ when a particular asset is proven to have an ascertainable value and a limited useful life.¹⁰

The decision was followed closely by the adoption of Internal Revenue Code [hereinafter “Code”] Section 197,¹¹ which provides a mandatory fifteen-year depreciation period for goodwill and other specified intangibles.¹² While Section 197 resolved many of the controversies regarding the depreciation of intangible assets (including goodwill), it also disadvantages taxpayers who acquire “Section 197 intangibles”¹³ with useful lives less than fifteen years.¹⁴

example, intangible assets include rights such as patents, copyrights, and trademarks, or an asset that lacks physical existence, such as goodwill. “A nonphysical, non-current asset which exists only in connection with something else, such as the goodwill of a business.” BLACK’S LAW DICTIONARY 808 (6th ed. 1990).

6. With goodwill being non-depreciable under the Internal Revenue Code prior to 1993, taxpayers sought to distinguish depreciable intangible assets from goodwill. In a report exploring the intangible asset conundrum, the GAO observed that IRS audits “most frequently challenged the classifications rather than the useful lives and/or values that taxpayers assigned to . . . intangible assets.” GAO/GGD-91-88, *supra* note 5, at 3. The rationale for this phenomenon is based simply on the time preference for money: it is more desirable to take current deductions against gross income over delaying until a later disposition of an asset because the opportunity-value of a quantum of money now is valued more highly than the same quantum in the future. BANKING TERMINOLOGY 274 (3d ed. 1989) (also called present value).

7. Justice Souter, writing for the dissent in *Newark Morning Ledger*, observed that “the law concerning the depreciation of intangible assets related to goodwill has developed on a case-by-case basis.” 113 S. Ct. 1670, 1685 n.4 (1993).

8. *Id.* at 1670.

9. *Id.* at 1683.

10. *Id.* at 1681 (“[A] taxpayer able to prove that a particular asset can be valued and that it has a limited useful life may depreciate its value over its useful life regardless of how much the asset appears to reflect the expectancy of continued patronage [goodwill] . . .”).

11. I.R.C. § 197. All citations to I.R.C. are to the Internal Revenue Code of 1986, as amended.

12. I.R.C. § 197(a) (“A taxpayer shall be entitled to an amortization deduction with respect to any amortizable Section 197 intangible. The amount of such deduction shall be determined by amortizing the adjusted basis . . . ratably over the 15-year period . . .”).

13. I.R.C. § 197(d) (listing “Section 197 intangible” assets).

14. The United States House of Representatives’ report concerning Section 197 recognized the detrimental tax effect on some intangibles: “It is recognized that the

Notwithstanding this Code change, the fuel for substantive controversy still exists for intangible assets falling both inside and outside the scope of Section 197. The ambiguity surrounding the nature of goodwill has not disappeared, and under certain circumstances, the incentive remains for taxpayers to avoid allocation of purchase price to goodwill when other assets have shorter useful lives.¹⁵ This lingering uncertainty will continue to strain the resources of both concerned taxpayers and the government unless the nature of goodwill is clarified within the Code and Treasury Regulations¹⁶ [hereinafter "Regulations"]. Despite the lack of statutory explicitness, however, the *Newark Morning Ledger* decision provides precedent whereby taxpayers may establish the propriety of claimed depreciation deductions for contested intangible asset depreciation.¹⁷

useful lives of certain acquired intangible assets to which the bill applies may be shorter than 14 years [changed to 15 years in Conference Committee], while the useful lives of other acquired intangible assets to which the bill applies may be longer than 14 years." H.R. REP. NO. 2141, 103d Cong., 1st Sess. 323 (1993), reprinted in *The Revenue Reconciliation Act of 1993*, 211 (Research Instit. Am. 1993); see also George Brode, Jr., *Structuring Taxable Acquisitions of Intangibles Under Section 197*, 60 TAX NOTES 1011, 1019-20 (1993) (providing further commentary on this point). The flat 15-year depreciation period for Section 197 intangibles was a revenue balancing measure that treated those intangibles with arguably shorter useful lives than 15 years (examples: covenants not to compete, patents, copyrights) the same as those with indeterminate useful lives (examples: goodwill and going-concern value). See Kevin M. Helmich, *The Amortization of Intangible Assets: An Analysis of H.R. 3035 Proposed by House Ways and Means Committee Chairman Dan Rostenkowski*, 55 TAX NOTES 987, 991-92 (1992) (advocating that most industries would not be affected by the offsetting losses and gains from a standardized amortization period).

15. See Russell W. Coff and Eric G. Flamholtz, *Corporate Investments in Human Capital: How Financial Accounting Standards Undermine Public Policy*, 5 STAN. L. & POL'Y REV. 31, 37 (Fall 1993) ("In its current form, this bill would create incentives to allocate the purchase price to equipment and other assets with a useful life of less than fourteen years and might actually provide a disincentive for acquiring land and buildings which have longer useful lives.").

16. At the end of 1993, over 8000 intangible-depreciation issues were pending before the IRS. *IRS Official Discusses Settlement of Intangibles Cases*, TAX NOTES TODAY (Nov. 4, 1993) (LEXIS, FEDTAX, TNT file, elec. cit. 93 TNT 2041). The GAO reported over 2100 open audit cases relating to intangible assets for the tax years 1979 to 1987. GAO/GGD-91-88, *supra* note 5, at 13. The Internal Revenue Service [hereinafter "Service" or "IRS"] has made efforts to dispose of many cases by way of a settlement initiative. *IRS Briefing Materials*, reprinted in TAX NOTES TODAY (Feb. 9, 1994) (LEXIS, FEDTAX, TNT file, elec. cit. 94 TNT 30-8); see also Ken C. Jones and Joan L. Rood, *Evaluating the Service's Settlement Initiative for Intangible Assets*, 80 J. TAX'N 196 (evaluating settlement offer); *IRS Offers to Settle Intangible Disputes*, 52 TAX'N FOR ACCT. 237 (April 1994) (evaluating settlement offer). While the number of classification cases might never again rise to the pre-Section 197 levels, the fundamental problem giving rise to the old cases still exists.

17. The Supreme Court in *Newark Morning Ledger* held that when a taxpayer meets the burden of proof that the disputed intangible asset has an ascertainable value and

This Comment recounts the case history leading up to the *Newark Morning Ledger* decision and identifies two major schools of thought concerning the definition of goodwill. These competing approaches are: (1) the substantivist school, which holds out a substantive, dispositive meaning of goodwill;¹⁸ and (2) the residualist school, which views goodwill as that which is "left-over" after accounting for all other identifiable assets.¹⁹ Next, it examines the *Newark Morning Ledger* controversy and decisions,²⁰ and concludes with an examination of its significance in light of Section 197.²¹ Generally, this Comment advocates the residualist method of defining goodwill as a viable and profitable basis for establishing the depreciation of intangible assets in the aftermath of Section 197. Three issues are identified where the *Newark Morning Ledger* decision continues to provide controlling precedent for the depreciation of intangible assets: (1) valuation issues,²² (2) duration issues,²³ and (3) characterization issues.²⁴

II. Statutory and Regulatory Framework

Depreciation deductions have been a part of the federal tax system since its inception.²⁵ More recently, Code Section 167 has allowed depreciation deductions for an asset's "exhaustion, wear and tear."²⁶ Pursuant to Section 167, Congress limits depreciation deductions to a "reasonable allowance"²⁷ for the wasting value of property used in a trade or business,²⁸ or property held for the production of income.²⁹ Under the Regulations³⁰ accompanying this section, the

a reasonably ascertainable limited useful life, the asset's relationship to goodwill is irrelevant. *Newark Morning Ledger*, 113 S. Ct. at 1680-81. By meeting this burden of proof, the taxpayer has proved that the asset does not have a useful life of infinite duration, but instead suffers wear and tear, a characteristic inconsistent with the traditional notion of goodwill. *Id.* at 1680.

18. See *infra* Part III.A.

19. See *infra* Part III.B.

20. See *infra* Part VI.A.

21. See *infra* Part VI.B.

22. See *infra* Part VI.B.1.

23. See *infra* Part VI.B.2.

24. See *infra* Part VI.B.3.

25. Tariff of 1909, § 38 Second, 36 Stat. 11, 115 (recognizing a "reasonable allowance for depreciation of [corporate held] property").

26. I.R.C. § 167(a). Quoted in full, Section 167(a) states: "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) (1) of property used in the trade or business, or (2) of property held for the production of income." *Id.*

27. *Id.*

28. *Id.*

29. *Id.*

amount deducted in any particular year must be within the parameters of a "consistent plan,"³¹ which is one resulting in the aggregate amount depreciated over the course of the asset's estimated useful life,³² plus any salvage value, equaling the cost of the asset.³³ Over the years, the basic form of this statute has undergone little change.³⁴

The Regulations accompanying Section 167 recognize depreciation deductions for both intangible³⁵ and tangible³⁶ properties. The two forms of property, however, depreciate differently. An intangible asset

30. Regulations are interpretations or clarifications of the provisions of the Internal Revenue Code, issued by the Treasury Department on the authority of Congress, that "carry the force" of the statute they interpret. WILLIAM A. RAABE ET AL., WEST'S FEDERAL TAX RESEARCH 577 (1994).

31. Treas. Reg. § 1.167(a)-1a (as amended in 1972). "The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate)" *Id.*

32. The asset's "useful life" is a reasonable estimate, not necessarily the inherent useful life of the asset. Treas. Reg. § 1.167(a)-1b (as amended in 1972). This estimate must be based on the period of time "the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income." *Id.* The useful life is established in accordance with the taxpayer's experience with similar property, taking into account the impact of present and probable future circumstances. *Id.* The Regulation also provides: "If the taxpayer's experience is *inadequate* [for determining useful life], the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination." *Id.* (emphasis added).

33. Treas. Reg. § 1.167(a)-1a (as amended in 1972). The Regulation states that the depreciation plan must achieve the following consistency:

[T]he aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in Section 167(g) and § 1.167(g)-1.

Id.

34. Changes to the statute were minor. The 1913 Revenue Act provided for the depreciation of property "used in the trade or business," while the 1942 Revenue Act added, "property held by the taxpayer for the production of income." 1913 Act, Sec. II, B; 1942 Act, Sec. 121(c). The most noteworthy changes came at the level of Treasury Decisions and Regulations. The Treasury Decision accompanying the Tariff of 1909 did not distinguish intangible from tangible property for the purposes of allowing a depreciation deduction. Treas. Reg. 31, Art. 4, p. 11 (1909). However, this changed in 1914, when the Treasury promulgated Treas. Reg. 33 (1914) under the 1913 Income Tax Law. In that Regulation, depreciation deductions were limited to tangible property. *Id.* See also *Newark Morning Ledger*, 113 S. Ct. at 1674 (providing a brief history of the depreciation deduction).

35. Treas. Reg. § 1.167(a)-3 (as amended in 1960) ("If an intangible asset is known . . . to be of use . . . for only a limited period . . . such an intangible asset may be the subject of a depreciation allowance.").

36. Treas. Reg. § 1.167(a)-2 (as amended in 1956) ("The depreciation allowance in the case of tangible property applies only to that part of the property which is subject to wear and tear . . .").

is depreciable³⁷ if it "is known . . . to be of use . . . for only a limited period, the length of which can be estimated with reasonable accuracy"³⁸ In contrast, more explicit Code provisions outline the depreciation of tangible property.³⁹ They provide for depreciation so long as the asset is "subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence."⁴⁰

Regulation Section 1.167(a)-3 specifically deals with the depreciation of intangible property.⁴¹ This Regulation provides for the possible depreciation of an intangible asset, known to be of use for a limited time, when that period can be estimated with reasonable accuracy.⁴² Under Section 167, an intangible asset with an unlimited useful life is not depreciable.⁴³ The taxpayer bears the factual burden to support a claimed deduction for an intangible asset, as no allowance will be made based on the taxpayer's "unsupported opinion."⁴⁴ Finally, this Regulation allows no deduction for the depreciation of goodwill.⁴⁵

A "floodtide"⁴⁶ of litigation has flowed from these concise guidelines.⁴⁷ The effect of denying depreciation for goodwill stimulated taxpayers to prove, whenever possible, that an intangible property was depreciable within the requirements of Regulation Section 1.167(a)-3.⁴⁸ Generally, conforming with the time-preference-for-money principle,⁴⁹ individuals value the current use of money more highly than future use. This principle, coupled with the non-depreciability of the intangible "goodwill" prior to section 197, produced an

37. See *supra* note 5 and accompanying text.

38. Treas. Reg. § 1.167(a)-3 (as amended in 1960).

39. Section 168 lists depreciation periods applicable to specific tangible assets under the accelerated cost recovery provisions. I.R.C. § 168(c).

40. Treas. Reg. § 1.167(a)-2 (as amended in 1956).

41. Treas. Reg. § 1.167(a)-3 (as amended in 1960).

42. *Id.* (providing depreciation allowances for intangible assets that are useful for "only a limited period, the length of which can be estimated with reasonable accuracy . . .").

43. *Id.* ("An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation.").

44. *Id.* ("No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life.").

45. *Id.* ("No deduction for depreciation is allowable with respect to good will."); see also *infra*, Part V (discussing I.R.C. § 197).

46. See *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1243 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974) ("These deceptively uncomplicated words have, however, led to a floodtide of litigated cases . . .").

47. *Id.*

48. Treas. Reg. § 1.167(a)-3 (as amended in 1960) ("If an intangible asset is known . . . to be of use . . . for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance.").

49. See *supra* note 6 and accompanying text.

incentive for taxpayers to distinguish depreciable intangible assets from goodwill, so as to recapture its cost sooner rather than later.⁵⁰

III. Goodwill and Caselaw History

The first case directly addressing the depreciation of goodwill was *Red Wing Malting Co. v. Willcuts*.⁵¹ The particular question before the Eighth Circuit in *Red Wing* was whether a malt barley manufacturer, whose market was destroyed as a result of the Prohibition Amendment,⁵² was entitled to a deduction because of the obsolescence of its goodwill.⁵³ The court affirmed the trial court in dismissing *Red Wing Malting's* petition.⁵⁴

In reaching its decision, the *Red Wing* court interpreted the scope of Section 234,⁵⁵ the predecessor to Code Section 167.⁵⁶ The court reasoned that while goodwill was indeed "property of an intangible nature,"⁵⁷ it was distinguishable from patents, copyrights and other intangibles in that goodwill was not susceptible to wear and tear.⁵⁸

50. See Michael J. Douglass, *Tangible Results For Intangible Assets: An Analysis of New Code Section 197*, 47 TAX LAW. 713, 713 (1994) ("To help minimize the amount of purchase price allocated to goodwill, taxpayers resorted to allocating purchase price to various intangible assets, such as 'recipes,' 'drawings,' and 'disadvantage competition,' and amortized such creative intangibles assets over their useful lives.") (footnote omitted).

51. 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1927) (affirming a judgment denying deductions for the obsolescence of goodwill).

52. U.S. CONST. amend. XVIII, *repealed by* U.S. CONST. amend. XXI.

53. 15 F.2d at 627-28.

54. 15 F.2d at 634 ("We have reached the conclusion that the action of the trial court in dismissing plaintiff's petition and rendering judgment for defendant was correct, and the same is affirmed.").

55. Revenue Act of 1918, § 234(a)(4), (7), ch. 18, 40 Stat. 1057, 1077-78 (1919).

56. 15 F.2d at 628. The particular portion of the provision quoted in the opinion reads:

That in computing the net income of a corporation subject to the tax imposed by Section 230 there shall be allowed as deductions: . . . (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise; . . . (7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

Revenue Act of 1918, § 234(a)(4), (7), ch. 18, 40 Stat. 1057, 1077-78 (1919).

57. *Red Wing Malting Co. v. Willcuts*, 15 F.2d 626, 632 (8th Cir. 1926), *cert. denied*, 237 U.S. 763 (1927).

58. 15 F.2d at 633. Quoting in relevant part:

We are satisfied there can be no wear or tear of good will, or exhaustion thereof by use, and, even should we assume that good will, separate and distinct from tangible property, is property used in the business, . . . the 1918 Revenue Act limits the allowance for obsolescence to such property as is susceptible to exhaustion, wear, and tear by use in the business, and good will is not such property.

Id.

Consequently, goodwill did not fit within the 1918 Revenue Act's allowance for obsolescence.⁵⁹ Following the court's decision in *Red Wing*, the Treasury Department amended the Regulations in 1927 to deny a depreciation deduction for goodwill.⁶⁰ This has been the Service's position ever since.⁶¹

Courts and commentators have observed that since 1927, the only question litigated in this area of law has been whether a particular intangible asset is goodwill, and therefore non-depreciable.⁶² Since

59. The conclusion of the court in *Red Wing Malting* contravened the Service's prior position of allowing depreciation deductions to distillers, dealers in liquors, and brewers for the obsolescence of goodwill destroyed by the prohibition legislation. See T.B.R. 44, 1 C.B. 133-34, 137-38 (1919); O.D. 298, 1 C.B. 138 (1919); see also O.D. 472, 2 C.B. 141 (1920) (permitting obsolescence of goodwill "in the case of the discontinuance of a going business because of the exhaustion of its source of supply, where the cost of the goodwill . . . can be definitely shown and the period of its obsolescence determined with reasonable accuracy."); O.D. 818, 4 C.B. 178-79 (1921) ("In the case of liquor dealers the useful life of whose intangibles, such as good will, trade-marks and trade brands, was definitely limited as a result of prohibition legislation, an allowance for obsolescence is permissible.").

60. T.D. 4055, 6-2 C.B. 63 (1927). The Service recognized the depreciability of goodwill as a result of the Prohibition Amendment between 1919 and 1927. Regulation 45, T.D. 2831, Art. 163 (1919) (providing for depreciation deductions); T.D. 4055, 6-2 C.B. 63 (1927) (prohibiting depreciation deductions). In relevant part, Regulation 45 stated:

Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. . . . Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance No deduction for depreciation . . . is allowable in respect of good will.

Regulation 45, T.D. 2831, Art. 163 (1919) (emphasis added). This provision was amended shortly thereafter to allow the depreciation of goodwill in light of the Prohibition Amendment. T.B.R. 44, 1 C.B. 133-34, 137-38 (1919). Following *Red Wing Malting*, the Treasury Department once again amended the Regulations, reinstating the provision that: "No deduction for depreciation, including obsolescence, is allowable in respect of good will." T.D. 4055, VI-2 C.B. 63 (1927).

61. *Newark Morning Ledger*, 113 S. Ct. at 1675 n.8; see also *Clarke v. Haberle Crystal Springs Brewing Co.*, 280 U.S. 384 (1930) (settling a conflict between jurisdictions by holding that when a liquor "business is extinguished as noxious under the Constitution" no depreciation deductions are allowed for the obsolescence of goodwill).

62. See, e.g., *Newark Morning Ledger*, 113 S. Ct. at 1675 (citing *Houston Chronicle*, 481 F.2d at 1247); UNITED STATES GENERAL ACCOUNTING OFFICE, GAO/GGD-91-88, *Tax Policy: Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets*, 15 (August 1991) ("Most of the current disagreements over the tax treatment of purchased intangible assets concern whether or not assets are separate from goodwill."); see also Gregorich, *supra* note 4, at 258-59 (stating that the litigated question has been "whether a particular intangible asset is non-amortizable, either because it is a

neither the Code nor the Regulations define the term "goodwill,"⁶³ the ensuing years have seen many controversies, particularly concerning customer-based intangibles,⁶⁴ with courts using markedly different analyses⁶⁵ to resolve the depreciability question.

It was *Houston Chronicle Publishing Co. v. United States*⁶⁶ that first brought clarity to the court conventions evaluating depreciation allowances for customer-based intangibles.⁶⁷ There, the Houston Chronicle Publishing Company [hereinafter "the Chronicle"] had acquired a competing local newspaper.⁶⁸ Among the assets purchased were all of the former newspaper's subscription lists.⁶⁹ The Chronicle claimed that the lists had an expected useful life of five years and sought depreciation deductions for a portion of that value.⁷⁰ When the IRS denied the deductions, the Chronicle filed

component of ordinary goodwill, or because it is so much like goodwill that the reasons for denying amortization deductions are fully applicable").

63. See Regulation 45, T.D. 2831, Art. 163 (1919); T.B.R. 44, 1 C.B. 133 (1919); T.D. 4055, VI-2 C.B. 63 (1927).

64. With the traditional description of goodwill being "the expectancy of continued patronage," it is not surprising that most tax controversies in this area involved customer-based assets, such as customer and subscription lists, insurance expirations, bank deposits, and "any other identifiable asset the value of which obviously depends on the continued and voluntary patronage of customers." *Newark Morning Ledger*, 113 S. Ct. at 1676 (1993) (recognizing that customer-based intangibles have given the IRS and the courts difficulty). See *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962) ("[T]he essence of goodwill is the expectancy of continued patronage, for whatever reason."). In other words, because Regulation § 1-167(a)-3 explicitly settled the idea that goodwill was non-amortizable as a matter of law, the only question remaining was "whether a particular asset is 'goodwill.'" *Houston Chronicle*, 481 F.2d at 1247.

65. In looking at the case law before it, the Fifth Circuit noted that "[n]o single rule for the tax treatment of 'intangible property' emerges from those cases and no black-letter statement of the applicable law is available to guide our decision." *Houston Chronicle*, 481 F.2d at 1243. See *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 685-87 (5th Cir. 1971) (affirming denial of deduction for acquisition costs of leaseholds); *Commissioner v. Seaboard Fin. Co.*, 367 F.2d 646, 652-53 (9th Cir. 1966) (affirming finding that 30 percent of premium attributable to goodwill); *Boe*, 307 F.2d at 339, 342-44 (affirming denial of deduction for acquisition of medical doctor's practice as it was indistinguishable from goodwill).

66. 481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974).

67. See *Newark Morning Ledger*, 113 S. Ct. at 1678 (noting that *Houston Chronicle* "clarified that the availability of the depreciation allowance was primarily a question of fact").

68. *Houston Chronicle*, 481 F.2d at 1243-44.

69. *Id.* The Houston Chronicle did not intend to continue operating its acquisition, the Houston Press Company, but considered the lists valuable anyway in light of the likelihood that some of the Press' former customers would become Chronicle subscribers. *Id.*

70. *Id.* at 1244.

suit and its contentions were put to a jury which found in its favor.⁷¹ The case went to the Fifth Circuit on appeal after the trial court denied the government's motion for judgment notwithstanding the verdict.⁷²

Rendering its opinion for the taxpayer, the Fifth Circuit held that the question of depreciability was indeed a fact question.⁷³ In so holding the court put to rest the notion that certain intangibles were non-depreciable as a matter of law.⁷⁴ In particular, the court noted the precedential irrelevance of the "mass asset"⁷⁵ rule. The mass asset rule denied depreciation deductions as a matter of law when individual assets,⁷⁶ or separate assets taken together,⁷⁷ were substantially related to "goodwill." The court characterized goodwill as "possessing no determinable useful life and having self-regenerating capability."⁷⁸ Instead of following this *per se* analysis, the court stated

71. *Id.* at 1244-45.

72. *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1245 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974).

73. *Id.* at 1253-54 ("Our view—that amortizability for tax purposes must turn on factual bases—is more in accord with the realities of modern business technology in a day when lists are bartered and sold as discrete vendible assets.").

74. *Id.* at 1249.

75. *Id.* at 1249-50. The "mass asset" rule finds its point of origin in *Danville Press, Inc. v. Commissioner*, 1 B.T.A. 1171 (1925). There, the court denied depreciation of a newspaper's 9,000 at-will subscriptions, reasoning that this type of intangible did not expire, but merely fluctuated in value "from time to time." *Id.* The mass-asset, or indivisible-asset, rule, according to the Supreme Court, provides

that certain kinds of intangible assets are properly grouped and considered as a single entity; even though the individual components of the asset may expire or terminate over time, they are replaced by new components, thereby causing only minimal fluctuations and no measurable loss in the value of the whole.

Newark Morning Ledger, 113 S. Ct. at 1676. The rule has been cited to support the notion that certain intangible assets, like goodwill, are *per se* non-depreciable because of their self-regenerating character. For example, a subscription list is composed of numerous individual subscribers whose subscriptions expire over time for various reasons. However, as some subscriptions terminate new subscribers replace those lost, resulting in only value fluctuations of the subscription list and no significant net loss overall. *See id.* at 1676.

76. *Houston Chronicle*, 481 F.2d at 1249 (referring to *Golden State Towel & Linen Serv. Ltd. v. United States*, 373 F.2d 938, 944 (Ct. Cl. 1967)).

77. *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1247 (5th Cir. 1973) (citing *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677 (5th Cir. 1971)), *cert. denied*, 414 U.S. 1129 (1974). The Fifth Circuit Court of Appeals stated that the "mass asset" principle applied in cases where "intangible assets are treated as a single entity which, unlike its individual components, is considered to have no determinate useful life and is nondepreciable." *Winn-Dixie Montgomery*, 444 F.2d at 686 (holding that the mass asset rule did not apply in a dispute over whether goodwill was purchased at all in the acquisition of a going-concern).

78. *Houston Chronicle*, 481 F.2d at 1249.

that case outcomes turned on the evidentiary support offered by taxpayers in support of their position.⁷⁹

The *Houston Chronicle* court established that depreciation deductions for the value of intangible assets were proper only when a taxpayer met a difficult evidentiary burden.⁸⁰ Taking into account Code Section 167(a) and Regulation 1.167(a)-3, the court articulated the following test: deductions were allowable only if "the taxpayer properly carries his dual burden of proving that the intangible asset involved (1) has an ascertainable value separate and distinct from goodwill, and (2) has a limited useful life, the duration of which can be ascertained with reasonable accuracy."⁸¹ Examining the record,⁸² the court concluded that the *Chronicle's* proffered evidence was sufficient to defeat the government's motion.⁸³

The years following the *Houston Chronicle* decision witnessed a re-drawing of the battle lines.⁸⁴ While courts consistently recognized that the depreciation deduction issue was a question of fact,⁸⁵ the

79. *Id.* ("Most of the cases purporting to apply the 'mass asset' rule involve evidentiary failures on the part of the taxpayer."). The Fifth Circuit supported its contention by citing *Thriftcheck Serv. Corp. v. Commissioner*, 287 F.2d 1 (2d Cir. 1961) which denied depreciation deductions for customer contacts based on the taxpayer's failure to prove a limited useful life and *Marsh & McLennan, Inc. v. Commissioner*, 420 F.2d 667 (3d Cir. 1969) which denied depreciation deductions on two grounds, one of which was the taxpayer's failure to prove a limited useful life with reasonable accuracy. *Houston Chronicle*, 481 F.2d at 1249.

80. *Houston Chronicle*, 481 F.2d at 1250.

81. *Id.*

82. Evidence that proved particularly significant for the court in sustaining the jury's verdict included testimony of the *Chronicle's* officers, testimony of employees and expert witnesses concerning the cost of obtaining new subscriptions, similar testimony regarding the useful life estimates of the subscription lists, and results taken from the *Chronicle's* survey of its current subscribers concerning the useful life of an average subscription. *Id.* at 1253.

83. *Id.* The court stated: "We think that this direct testimony rises above the level of 'unsupported opinion of the taxpayer' and thus satisfies . . . Treas. Reg. § 1.167(a)-3 . . . and we conclude that the very able trial judge correctly submitted the case to the jury." *Id.*

84. See Reuven S. Avi-Yonah, "Amortization of Intangibles," 533 T.M. A-21. Mr. Avi-Yonah notes:

From 1973 to 1993, the IRS attempted to attack taxpayers' amortization deductions arguing that certain intangibles are by their nature or definition inseparable from goodwill or going concern value and, therefore, do not meet the two-pronged test of *Houston Chronicle*. In essence, the IRS attempted to add to the test a third, definitional prong, requiring that an asset be separate and distinct from goodwill as well as have an ascertainable value and limited useful life.

Id.

85. See, e.g., *Donrey, Inc. v. United States*, 809 F.2d 534, 536 (8th Cir. 1987) (maintaining that taxpayer was entitled to depreciation deduction for subscription list

identification of non-depreciable goodwill branched into two schools of thought. On one hand, the concept of goodwill was seen as the expectancy of continued patronage.⁸⁶ Under this approach, deductions were improper for any intangible that could not be adequately distinguished from the over-arching notion of customer patronage.⁸⁷ Alternatively, it was argued that Code Section 167 and Regulation Section 1.167(a)-3 premised an intangible asset's depreciation on whether it had a limited useful life that could be determined with reasonable accuracy.⁸⁸ Goodwill, however, was presumed to have "a useful life of indefinite duration."⁸⁹ Consequently, goodwill was the remaining intangible after all other assets with reasonably ascertainable useful lives were distinguished.⁹⁰ These alternative tests for identifying depreciable intangibles from goodwill may be denominated, respectively, (1) the substantivist⁹¹ school and (2) the residualist school.⁹²

of newspaper it purchased and that evidence substantiated that the subscription list had a useful life of twenty-three years and had "ascertainable value separate and distinct from goodwill"); *General Television, Inc. v. United States*, 449 F. Supp. 609, 611 (D. Minn. 1978), *aff'd per curiam*, 598 F.2d 1148 (8th Cir. 1979); *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446, 452 (Ct. Cl. 1976) ("Entitlement to a depreciation allowance is a question of fact and not of law."); *Sunset Fuel Co. v. United States*, 519 F.2d 781, 784 (9th Cir. 1975).

86. See *Boe*, 307 F.2d at 343; *AmSouth Bancorporation v. United States*, 681 F. Supp. 698 (N.D. Ala. 1988).

87. See *Sunset Fuel*, 519 F.2d at 783 & n.2 (noting that at-will customers individually and aggregately were non-depreciable intangible assets because they were "essentially goodwill themselves," giving the taxpayer the "opportunity and expectation of future patronage").

88. Treas. Reg. § 1.167(a)-3 (1994). The Regulation states:

If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance.

Id.

89. See *Richard S. Miller*, 537 F.2d at 452 ("[T]he most significant indication that an intangible asset is separate and distinct from goodwill is whether its useful life can be shown with reasonable accuracy to be of limited duration.").

90. See Note, *Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill*, 81 HARV. L. REV. 859, 861 (1968) (advocating goodwill is the "residual intangible asset"); McDonald, *supra* note 1, at 648 (describing goodwill as the "indefinable something left over").

91. The substantivist test might also be called the "separate and distinct" test, derived from the language of Regulation § 1.167(a)-3. See Sarah R. Lyke, Note, *INDOPCO, Inc. v. Commissioner: National Starch Decision Adds Wrinkles to Capital Expenditure Issue*, 88 NW. U. L. REV. 1239 (1994) (examining the issue of distinguishing deductible expenses from capital expenditures); Mark B. Persellin, *Depreciation of Customer-Based Intangibles Confirmed by Supreme Court in Newark Morning Ledger*, 45 TAX EXEC. 211, 213-14 (May-June 1993) (examining the appellate process in *Newark Morning Ledger*).

A. *The Substantivist Approach*

One way in which courts have addressed the intangible asset depreciation issue is by quantifying the closeness of the relationship between goodwill and the asset in question.⁹³ As the name suggests, substantivists regard goodwill as having a substantive definition⁹⁴—the expectancy of continued patronage—that is dispositive of depreciability.⁹⁵ This approach incorporates a weighty presumption that customer-based intangibles are non-depreciable because of their close relationship to the notion of customer patronage.⁹⁶ To summarize the substantivist approach: if an intangible asset looks substantially similar to the expectancy of continued patronage, then it is non-depreciable.⁹⁷

An example of the substantivist school of thought is *General Television, Inc. v. United States*.⁹⁸ In *General Television*, a community

92. See *infra* Part III.B.

93. See *General Television*, 449 F. Supp. at 611 (“Whether a particular intangible capital asset may be depreciated . . . depends upon its identification with goodwill.”); *Sunset Fuel*, 519 F.2d at 782-83 & n.2 (holding no depreciation for customer list since it, and the individual terminable-at-will customers, were “essentially goodwill themselves”); *Boe*, 307 F.2d at 342 (holding no depreciation for terminable-at-will contracts since they “gave sufficient assurance of continued patronage,” i.e., were goodwill).

94. *Newark Morning Ledger*, 113 S. Ct. at 1674 (“The court concluded that goodwill has a *substantive* meaning—the expectancy that ‘old customers will resort to the old place of business’”) (quoting *Newark Morning Ledger Co. v. United States*, 945 F.2d 555, 567-68 (3d Cir. 1991)) (emphasis added).

95. See, e.g., *Golden State Towel*, 373 F.2d at 944 (stating that the “principal element of . . . goodwill . . . lies in the expectancy of continued patronage through public acceptance”).

96. *Newark Morning Ledger*, 113 S. Ct. at 1676 (noting that “customer-based intangibles” have given the Service and the courts difficulty). Customer-based intangible is a name commonly given to an asset whose value is linked to the “continued and voluntary patronage of customers,” including customer and subscriber lists, insurance expirations, and bank deposits. *Id.*

97. See *General Television*, 449 F. Supp. at 612-13 (denying depreciation for subscriber contracts because they were essentially the “expectancy of continued patronage”); cf. *Newark Morning Ledger*, 113 S. Ct. at 1680 n.13 (“The dissent’s mistake is to assume that because the ‘paid subscribers’ asset looks and smells like the ‘expectancy of continued patronage,’ it is, *ipso facto*, nondepreciable.”).

98. 449 F. Supp. 609 (D. Minn. 1978), *aff’d per curiam*, 598 F.2d 1148 (8th Cir. 1979). Less than a decade later the Eighth Circuit, in *Donrey, Inc. v. United States*, commented that *General Television* was actually consistent with the residualist approach, but had “simply applied the same test as used herein and reached a different conclusion based on different facts.” *Donrey, Inc. v. United States*, 809 F.2d 534, 537 (8th Cir. 1987). A close reading of *General Television*, however, reveals its substantivist analysis. See *Newark Morning Ledger*, 945 F.2d at 566 (citing *General Television* in support of its conclusion that prevailing law embraced the non-depreciability of any intangible

television corporation was denied depreciation deductions for subscriber lists acquired from several companies.⁹⁹ The court initially observed that allowance for the depreciation of intangibles was a fact question¹⁰⁰ and depended upon an asset's "identification with goodwill."¹⁰¹ These subscriber lists were distinguishable from other customer lists that had an "ascertainable value separate and apart from goodwill."¹⁰² As its rationale, the court held that these lists were actually "customer structures which included the expectancy of continued patronage."¹⁰³ Since the expectancy of continued patronage is the essence of goodwill, the lists were non-depreciable.¹⁰⁴

B. The Residualist Approach

Alternatively, the residualist approach emphasizes the process of identifying goodwill, as opposed to substantively defining it.¹⁰⁵ This

that could not be adequately distinguished from goodwill, i.e., the expectancy of continued patronage).

99. General Television purchased the assets of Delmarva Community Antenna Corporation, Peninsula Community Television Company and Diamond State CATV, Inc., of which intangible assets were valued at over \$850,000. *General Television*, 449 F. Supp. at 610-11.

100. *General Television*, 449 F. Supp. at 611 (citing *Houston Chronicle*, 481 F.2d at 1249).

101. *General Television*, 449 F. Supp. at 61, *aff'd per curiam*, 598 F.2d 1148 (8th Cir. 1979). The court identified several aspects that were incorporated in the concept of goodwill, including the notion of "indefinite duration," and self-regeneration. *Id.* What was dispositive, however, was the court's observation that "the expectancy of continued patronage is the essence of goodwill." *Id.* at 612.

102. *Id.* at 610-11. The court cited several cases, including *Houston Chronicle*, as examples of types of customer or subscriber lists that had an ascertainable value separate and apart from goodwill. *Id.*

103. *General Television, Inc. v. United States*, 449 F. Supp. 609, 612 (D. Minn. 1978), *aff'd per curiam*, 598 F.2d 1148 (8th Cir. 1979). Quoting in relevant part:

[W]hat the plaintiff purchased was more than mere subscriber lists which could be used to identify potential customers; what it purchased was customer structures which included the expectancy of continued patronage. Therefore, because the purchases of the subscriber lists were actually purchases of customer structures with the expectancy of continued patronage and because the expectancy of continued patronage is the essence of goodwill, the subscriber lists constitute non-depreciable goodwill.

Id.

104. *General Television*, 449 F. Supp. at 612. The opinion was silent with regard to the duration of the subscriber lists' useful life, which the court had made a point of stating was an element of goodwill. *Id.* at 611 (citing *Houston Chronicle*).

105. See, e.g., *IT & S of Iowa, Inc. v. Commissioner*, 97 T.C. 496, 508 (1991) (stating that whether a core deposit intangible was separate and distinct from goodwill was essentially a factual inquiry determined by proper identification of the intangible asset); *Colorado Nat'l Bankshares, Inc. v. Commissioner*, 60 T.C.M. 771, 789 (1990) (purporting that amortizable assets include those intangible assets which are

school of thought gains its name from equating goodwill with the excess value over and above the value of all other tangible and intangible assets in a business.¹⁰⁶ The concept is consistent with the Code's requirement of allocating purchase price across all acquired property.¹⁰⁷

For example, in the sale of a business the total purchase price is allocated among the acquired assets in order to determine the value of each item.¹⁰⁸ If the sale price is less than the sum of the values of the individual assets, then the valuation attached to the individual assets are reduced proportionately.¹⁰⁹ When the purchase price exceeds the value of tangible assets and identifiable intangibles the remainder, or residual, is allocated to goodwill.¹¹⁰ To summarize the residualist approach: if the intangible asset's useful life is not amenable to a reasonable estimation of time, then it is not separate and distinct from goodwill and is therefore non-depreciable.¹¹¹

One of the clearest statements of the residualist position arose in *Donrey, Inc. v. United States*.¹¹² Donrey had purchased an Indiana community newspaper for approximately \$1.3 million.¹¹³ Acquired

identifiable); *Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463, 480 (1988) (focusing on what intangible asset is being valued and depreciated as goodwill) *aff'd*, 900 F.2d 266 (11th Cir. 1990).

106. See *Newark Morning Ledger*, 945 F.2d at 564 (noting the alternative definition "equates goodwill with . . . the residual intangible asset that generates earnings in excess of a normal return . . .") (emphasis added).

107. See Reuven S. Avi-Yonah, *Amortization of Intangibles*, 533 T.M. A-4 (noting that the prohibition against goodwill depreciation "underlied the residual method of allocating purchase price"); George Mundstock, *Taxation of Business Intangible Capital*, 135 U. PA. L. REV. 1179, 1206-07 & nn.142-47 (1987) ("When the purchase price exceeds the value of tangible assets plus identifiable intangibles, the excess consideration is allocated to goodwill.").

108. I.R.C. §§ 338(b)(5), 1060; see Mundstock, *supra* note 107, at 1206-07 & nn.142-47 (describing purchase price allocation under I.R.C. §§ 338 and 1060).

109. See Mundstock, *supra* note 107, at 1206-07 & nn.142-47.

110. Treas. Reg. § 1.167(a)-5 (as amended by T.D. 8069, 51 Fed. Reg. 1498 (1986)); see Mundstock, *supra* note 107, at 1206-07.

111. See *Newark Morning Ledger*, 113 S. Ct. at 1680 n.13.

[W]hether or not an asset is depreciable is not a question to be settled by definition. 'Goodwill' remains nondepreciable under applicable regulations. . . . In interpreting those regulations, however, . . . [if] an asset [is] found to have a limited useful life and an ascertainable value which may be determined with reasonable accuracy, it is depreciable. By definition, therefore, it is not goodwill.

Id. Articulated another way, goodwill is "no more than the residual value that remains after all assets with determinable useful lives and ascertainable values have been accounted for." *Newark Morning Ledger*, 945 F.2d at 560 (summarizing Morning Ledger's argument).

112. 809 F.2d 534 (8th Cir. 1987).

113. *Donrey*, 809 F.2d at 535.

in the transaction was a customer list of over 10,000 terminable-at-will subscribers.¹¹⁴ Donrey claimed depreciation deductions, which the IRS denied, for a portion of the purchase price it allocated to the subscription list.¹¹⁵ Subsequently, a jury trial resulted in a verdict for the taxpayer¹¹⁶ and the government appealed.¹¹⁷

The Eighth Circuit Court of Appeals affirmed the judgment of the district court.¹¹⁸ In arriving at its conclusion, the court initially noted that the authority for depreciation deductions rested in Code Section 167(a),¹¹⁹ which states that a deduction is permissible for “the exhaustion, wear and tear . . . of property used in the trade or business’ of a taxpayer.”¹²⁰ The court then stated that “[g]oodwill is conclusively presumed to have an unlimited useful life and as such is ineligible per se for the depreciation deduction.”¹²¹ Those two observations, coupled with the guidelines of the *Houston Chronicle* test,¹²² satisfied the court that the jury’s findings of an ascertainable value and limited life were reasonable given the facts, and consequently the deductions were proper.¹²³

114. *Id.*

115. *Id.*

116. *Id.* The jury answered special interrogatories and found: (1) that the subscription list had a limited useful life; (2) that the duration of the useful life was ascertainable with reasonable accuracy; (3) that the useful life of the list was twenty-three years; (4) that it had an ascertainable value separate and distinct from goodwill; and (5) that the value was \$559,406. *Id.* at 536.

117. *Id.* at 535. The district court denied the government’s motions for judgment notwithstanding the verdict and a new trial, concluding that the verdict “was not contrary to the great weight of the evidence.” *Id.* at 535-36.

118. *Donrey, Inc. v. United States*, 809 F.2d 534, 537 (8th Cir. 1987).

119. *Id.* at 536.

120. *Id.* (quoting I.R.C. § 167(a)).

121. *Id.* at 536 (citing Regulation § 1.167(a)-3 and *General Television*, 449 F. Supp. at 611). This proposition is consistent with a number of cases, particularly within the Court of Claims and Tax Court. See, e.g., *Richard S. Miller*, 537 F.2d at 452 (“The most important criterion is whether in fact it is a wasting asset.”); *Manhattan Co. of Virginia v. Commissioner*, 50 T.C. 78, 88 (1968) (“Goodwill has uniformly been held not to be subject to depreciation since it is not generally a wasting asset of the business to which it attaches, but rather an asset with an indefinite useful life.”); see also GAO/GGD-91-88, *supra* note 59, at 18 (“In 1927, the Department of the Treasury published regulations containing the first statement that goodwill is not amortizable. Goodwill was generally viewed as having an indeterminable useful life.”).

122. *Donrey*, 809 F.2d at 536-37 (“The parties agree that the leading case involving the depreciability of a newspaper subscription list is *Houston Chronicle* . . .”) (citation omitted).

123. *Id.* at 537.

IV. Newark Morning Ledger: Transaction and Court Decisions

No recent case has so clearly framed the historical debate over the treatment of intangibles as *Newark Morning Ledger Co. v. United States*.¹²⁴ The competing notions of goodwill proved to be the pivotal issue on which the various reviewing courts based their contrary opinions.¹²⁵ After an initial verdict in favor of the taxpayer,¹²⁶ the Third Circuit Court of Appeals reversed,¹²⁷ aligning itself steadfastly with the substantivist approach.¹²⁸ In a five-four decision,¹²⁹ the Supreme Court reversed again, advancing the residualist methodology.¹³⁰

A. The Acquisition

In 1976, over the course of several months, the Herald Company [hereinafter "Herald"] purchased all the outstanding stock of Booth Newspapers, Inc. [hereinafter "Booth"].¹³¹ At that time, Booth, a Michigan corporation that published eight daily and Sunday newspapers, had a total at-will¹³² subscription of approximately 460,000.¹³³ Herald liquidated the Booth stock in 1977 pursuant to Code Sections 332 and 334(b)(2).¹³⁴ These sections required Herald's adjusted

124. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670 (1993).

125. *Id.* at 1680-81 (holding any asset is depreciable whenever its value and limited useful life is proved, regardless of how much it appears to resemble continued patronage [(goodwill)]); *Newark Morning Ledger*, 945 F.2d at 566 (holding that a purchased subscriber list is non-depreciable because it is a customer structure that includes the expectancy of continued patronage, which is the essence of non-depreciable goodwill); *Newark Morning Ledger Co. v. United States*, 734 F. Supp. 176, 185 (D.N.J. 1990) (holding that Morning Ledger was entitled to depreciate the paid subscribers because it had established that the subscribers had limited useful lives and ascertainable value separate from goodwill).

126. *Newark Morning Ledger*, 734 F. Supp. at 185.

127. *Newark Morning Ledger*, 945 F.2d at 568-69.

128. *Newark Morning Ledger*, 945 F.2d at 568 (concluding that the district court applied the wrong definition of goodwill and if the correct definition had been applied, "it [would have been] clear that Morning Ledger ha[d] not satisfied its burden").

129. *Newark Morning Ledger*, 113 S. Ct. at 1670. Justices Blackmun, Stevens, O'Connor, Kennedy, and Thomas comprised the majority with Chief Justice Rehnquist and Justices Souter, White, and Scalia dissenting. *Id.* at 1671-72.

130. *Newark Morning Ledger*, 113 S. Ct. at 1680-81 (holding that an asset is depreciable whenever its value and limited useful life is proved, "regardless of the fact that its value is related to the expectancy of continued patronage").

131. *Newark Morning Ledger*, 945 F.2d at 556.

132. The subscribers' relationship with the newspaper was terminable-at-will, meaning that they were under no contractual obligation to continue their subscriptions into the future. *Id.*

133. *Id.* at 556.

134. *Id.*

basis¹³⁵ in Booth's stock, \$328 million, to be allocated among Booth's depreciable and non-depreciable assets in accordance with the respective fair market values of the assets.¹³⁶ Herald allocated about \$234 million among various financial and tangible assets.¹³⁷ The remaining \$94 million was allocated among three intangible assets: goodwill¹³⁸ and going-concern value¹³⁹ combined, and "paid subscribers."¹⁴⁰

The asset categorized as "paid subscribers" represented the dollar amount of estimated future profits to be derived from the 460,000 at-will subscribers acquired from Booth.¹⁴¹ To this asset, Herald assigned \$67.8 million as adjusted basis.¹⁴² On its tax returns for 1977 through 1980, Herald claimed deductions for assets acquired in the Booth transaction.¹⁴³ Consistent with then-current law, Herald made no attempt to claim depreciation for goodwill and going-concern value.¹⁴⁴ Herald did, however, claim a depreciation deduction for a portion of the \$67.8 million allocated to paid subscribers.¹⁴⁵ The Service disallowed these deductions on the ground that they should have been included in the amount allocated to non-depreciable goodwill.¹⁴⁶ As a result, the Service determined that Herald owed taxes and interest for each of the four years Herald had taken the depreciation deduction on its tax returns.¹⁴⁷ Consequently, Herald paid the arrears in full.¹⁴⁸

135. Adjusted basis is the cost, or other basis, of property reduced by depreciation taken and increased by capital improvements. BLACK'S LAW DICTIONARY 43 (6th ed. 1990).

136. *Newark Morning Ledger*, 945 F.2d at 556.

137. *Id.*

138. See *supra* note 1 and accompanying text.

139. Going-concern value is "the ability of a business to generate income without interruption, even though there has been a change in ownership." *Ithaca Indus. v. Commissioner*, 17 F.3d 684, 687 (4th Cir. 1994) (quoting language from *Ithaca Indus. v. Commissioner*, 97 T.C. 253 (1991)). The court noted that goodwill and going-concern value are often referred to "conjunctively." *Id.* However, going-concern relates to the continuity of income generation, while goodwill refers to the continuity of the business relationship. *Id.*

140. *Newark Morning Ledger*, 734 F.Supp at 179.

141. *Newark Morning Ledger*, 113 S. Ct. at 1672-73.

142. *Id.*

143. *Id.* at 1673.

144. Brief for Petitioner at 5-6, *Newark Morning Ledger Co. v. United States*, 945 F.2d 555 (3d Cir. 1991) (No. 91-1135), *reprinted in*, 25 LAW REPRINTS, THE SUPREME COURT OF THE UNITED STATES No. 5: NEWARK MORNING LEDGER CO. VERSUS UNITED STATES OF AMERICA 153, 157-58 (1992-93).

145. *Newark Morning Ledger*, 113 S. Ct. at 1673.

146. *Newark Morning Ledger*, 734 F. Supp. at 177.

147. *Newark Morning Ledger*, 945 F.2d at 557.

148. *Id.*

In 1987, Herald merged into Newark Morning Ledger Company [hereinafter "Morning Ledger"], a New Jersey corporation.¹⁴⁹ The following year, Morning Ledger claimed a refund with the IRS for the contested amount of paid taxes for "paid subscribers."¹⁵⁰ The Service allowed the statutory period to lapse without taking action on the refund claim.¹⁵¹ Subsequently, Morning Ledger filed suit to recover federal income taxes and interest it claimed the Service erroneously assessed and collected.¹⁵²

B. The District Court

The case came before the district court of New Jersey as a Section 167 controversy.¹⁵³ At trial, Morning Ledger made strategic use of expert witnesses to meet its burden under Section 167.¹⁵⁴ To prevail, Morning Ledger had to establish that the subscriber list was an asset of limited useful life and had an ascertainable value separate and apart from goodwill.¹⁵⁵ Experts were used to establish a value for the paid subscribers¹⁵⁶ and to quantify their useful lives.¹⁵⁷ Both sets of facts were essential for satisfying the two prongs of the *Houston Chronicle* test,¹⁵⁸ which was the standard employed by the court for evaluating the case.¹⁵⁹ While the government contested the method-

149. *Id.*

150. *Id.*

151. *Id.* Code Section 6532(a) confers refund suit jurisdiction on the court after the Service either denies the claim or after six months have lapsed, whichever comes first. 26 U.S.C. § 6532(a) (1988). See generally STEVEN C. SALCH ET AL., TAX PRACTICE BEFORE THE IRS §§ 15.36-15.38 (Shepard's/McGraw-Hill, Inc. 1994) (discussing how the IRS' refund claim procedure).

152. *Newark Morning Ledger*, 945 F.2d at 557.

153. *Newark Morning Ledger*, 734 F. Supp. at 184.

154. See *id.* at 177-81.

155. *Id.* at 184.

156. *Id.* at 179 (determining goodwill value through the residual method). Morning Ledger's experts, Messrs. Berkey and Grabowski, established the value of the subscription lists by computing after-tax subscription revenues derived from the paid subscribers, subtracting the collection costs of those revenues, and adding the present value of the tax savings which resulted from the depreciation of the subscriber list. *Newark Morning Ledger*, 734 F. Supp. at 183.

157. *Id.* at 180-81. The court noted that Morning Ledger's statistical expert, Dr. Glasser, employed widely accepted statistical techniques. *Id.* at 181.

158. See *supra* notes 80-81 and accompanying text.

159. *Newark Morning Ledger*, 734 F. Supp. at 184-85. In the words of the court: "To depreciate an intangible asset, a taxpayer must demonstrate as a factual matter that the asset has: a limited useful life, the duration of which can be estimated with reasonable accuracy, and an ascertainable value separate and apart from goodwill." *Id.* at 184.

ology of Morning Ledger's valuation approach, it offered no evidence to challenge the accuracy of the results obtained.¹⁶⁰

The court addressed the issue of goodwill within the context of the *Houston Chronicle* test.¹⁶¹ The pivotal consideration was whether the intangible asset "paid subscribers"¹⁶² was separate and distinct from goodwill.¹⁶³ By definition, the court reasoned, goodwill was a non-wasting asset and was valued using the residual approach.¹⁶⁴ The court contrasted the non-wasting character of goodwill against the facts established by Morning Ledger; that the list of paid subscribers had an ascertainable limited life estimated with reasonable accuracy and was valued directly.¹⁶⁵ To the court, these characteristics sufficiently separated "paid subscribers" from the concept of goodwill.¹⁶⁶ Likewise, the court observed that simply because the expenses incurred to maintain the asset were deductible did not mandate a finding that the asset itself was not depreciable.¹⁶⁷ Consequently, the

160. *Id.* at 181-82. The Supreme Court noted that the IRS made Morning Ledger's burden lighter by stipulating to the value and useful lives of the paid subscribers. *Newark Morning Ledger*, 113 S. Ct. at 1681. The thrust of the Service's argument rose and fell on the issue of characterization: that a customer-based intangible is indistinguishable from goodwill. *Newark Morning Ledger*, 734 F. Supp. at 184-85.

161. *Newark Morning Ledger*, 734 F. Supp. at 182-85.

162. *Id.* at 182-84. The court made it clear that "[g]oodwill is conclusively presumed, per se, not to be depreciable." *Id.* at 184.

163. *Id.* at 184.

164. *Id.* at 182 ("Goodwill, by definition, has an indefinite life and is valued using the residual method.").

165. *Newark Morning Ledger Co. v. United States*, 734 F. Supp. 176, 182 (D.N.J. 1990).

166. *Id.* at 176-77. The following excerpt displays the district court's analysis: [T]he court recognizes and accepts that goodwill is the expectancy that former customers will be retained—that there will be continued patronage. However, one must distinguish between a galaxy of customers who may or may not return, whose frequency is unknown, and whose quantity and future purchases cannot be predicted, against subscribers who can be predicted to purchase the same item, for the same price on a daily basis. Although newspaper subscribers are under no legal obligation to continue their subscriptions, expert opinion and the evidence presented coupled with the common sense and experience leads inescapably to the conclusion that the income derived from such paying subscribers will recur, which, in turn, permits the ascertainment of value separate and apart from goodwill. The income derived from the subscribers permits the calculation of value over the useful lives of the subscriptions or subscribers, and renders the subscribers acquired subject to valuation as an asset separate and apart from goodwill.

Id.

167. *Id.* at 180 (noting that despite expensive efforts made to generate new subscribers, Morning Ledger's market share had declined significantly over the last 20 years). *Contra* Calvin H. Johnson, *The Mass Asset Rule Reflects Income and Amortization Does Not*, 56 TAX NOTES 629 (1992) (advocating against depreciation deductions for customer-based intangibles when replenishment of customers is accomplished with

court concluded that Morning Ledger was entitled to depreciate the value of its paid subscriber lists over their stipulated useful lives.¹⁶⁸

C. *The Third Circuit Court of Appeals*

On appeal by the Government, the Third Circuit Court of Appeals reversed the district court on an error of law, stating that the district court had applied the wrong definition of goodwill.¹⁶⁹ The court, while recognizing the split in authority,¹⁷⁰ determined that the district court followed a minority view.¹⁷¹ According to the Third Circuit, the more appropriate test for determining the depreciability of an intangible was when a taxpayer could demonstrate that the asset was distinct from the notion of goodwill as the “probability that old customers will resort to the old place.”¹⁷² The court held that Morning Ledger’s subscriber list was inseparable from the expectancy of continued customer patronage.¹⁷³

Citing the pivotal *Houston Chronicle* case, the Third Circuit made two noteworthy observations. First, the court stated that the mass-asset rule¹⁷⁴ had no application to this controversy because the principle

deducted expenses).

168. *Newark Morning Ledger*, 734 F. Supp. at 178-79 (noting that the parties agreed to the total fair market value arrived at by expert witnesses).

169. *Newark Morning Ledger*, 945 F.2d at 568 (“We conclude, in short, that the district court applied the wrong definition of ‘goodwill.’”). As recognized by the court below, whether a taxpayer had met the requirements for depreciating an intangible asset was generally a question of fact, consequently the court’s review was based on a “clearly erroneous” standard with de novo review of any misinterpretation or misconstrual of law. *Id.* at 558.

170. See *supra* notes 84-92 and accompanying text.

171. The Third Circuit, looking at *Houston Chronicle Publishing Co. v. United States* and *Donrey, Inc. v. United States* in particular depth, observed that Morning Ledger “greatly overstated” the division in case law over the issue of characterizing goodwill. *Newark Morning Ledger*, 945 F.2d at 563. In the midst of its review, however, the court admitted “[t]he unavoidable fact is that there does exist authority bolstering Morning Ledger’s position.” *Id.* at 565. The third circuit dismisses these cases as nothing more than a “minority strand amid the phalanx of cases that have considered the definition and application of the term ‘goodwill’ in the context of § 1.167(a)-3, and which support the Service’s position.” *Id.* The court concluded that the great weight of authority supported the Service’s reading of *Houston Chronicle*. *Id.* at 563. However, the court avoided a detailed case law analysis, reasoning that the “amount of ink . . . spilled over this subject already” was sufficient. *Id.* Instead, a cursory overview of relevant case law became the heart of the court’s reversal. *Newark Morning Ledger*, 945 F.2d at 565-67.

172. *Newark Morning Ledger*, 945 F.2d at 565.

173. *Id.* at 568 (“[F]or tax purposes, there are some intangible assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable.”).

174. See *supra* notes 77-80 and accompanying text (per se denying depreciation deductions for assets possessing no determinable useful lives).

had been outdated since *Houston Chronicle*.¹⁷⁵ Second, the Third Circuit adopted the Service's interpretation of the two-pronged *Houston Chronicle* test.¹⁷⁶ In light of its holding,¹⁷⁷ the Court concluded that the district court had erred by ignoring the additional requirement that paid subscribers be shown to be "separate and distinct from goodwill."¹⁷⁸ This requirement was consistent with the explicit statement in the Regulations that "[n]o deduction for depreciation is allowable with respect to goodwill."¹⁷⁹ The court concluded that the second prong of the test, that the asset "has a limited useful life, the duration of which can be ascertained with reasonable accuracy,"¹⁸⁰ did not have a dispositive bearing on whether the intangible asset was "goodwill."¹⁸¹ Consequently, the Third Circuit agreed with the Service's position that some intangible assets were not depreciable, despite having limited useful lives estimable with reasonable accuracy, because those assets were otherwise indistinguishable from the traditional notion of goodwill.¹⁸²

175. *Newark Morning Ledger*, 945 F.2d at 561-62 (reading *Houston Chronicle* as rejecting the mass-asset rule).

176. *Id.* at 562-63; see *supra* text accompanying note 81.

177. The Service argued that the two-pronged test articulated in *Houston Chronicle* meant that depreciation was appropriate only in those circumstances where intangible assets were "separate and distinct" from the legal notion of "expectancy of continued patronage." *Newark Morning Ledger*, 945 F.2d at 562.

178. *Id.* at 568.

179. Treas. Reg. § 1.167(a)-3 (as amended in 1960).

180. *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1250 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974). The seminal passage from that decision states the following:

Without compiling the myriad cases that discuss the "mass asset" rule, we are satisfied that the rule does not establish a *per se* rule of non-amortizability in every case involving both goodwill and other intangible assets. In the light of § 167(a) of the Code and Regulation § 1.167(a)-3, we are convinced that the "mass asset" rule does not prevent taking an amortization deduction if the taxpayer properly carries his dual burden of proving that the intangible asset involved (1) has an ascertainable value separate and distinct from goodwill, and (2) has a limited useful life, the duration of which can be ascertained with reasonable accuracy.

Id. at 1249-50.

181. *Newark Morning Ledger*, 945 F.2d at 567-68.

182. *Id.* at 568; see also Marc D. Levy et al., *Supreme Court's Decision on Amortizing Intangibles Removes One Barrier*, 79 J. TAX'N 4 (July 1993) (providing brief summation of the Third Circuit's opinion).

D. The Supreme Court

With the narrowest majority,¹⁸³ the Supreme Court reversed the Third Circuit on error of law, holding that it had advanced the wrong definition of goodwill as dispositive of depreciation.¹⁸⁴ The Court observed that while the commonly cited description of goodwill as “the expectancy of continued patronage”¹⁸⁵ was a useful label, it was of little help to taxpayers trying to determine which of its assets qualified for depreciation deductions.¹⁸⁶ The majority opinion noted that every intangible asset is associated to some extent with customers’ repeat business (goodwill).¹⁸⁷ Despite this association, the Code permits depreciation for some intangible assets.¹⁸⁸ Consequently, the Court emphasized that the appropriate question was not how closely related to the expectancy of continued patronage is the intangible asset, but instead, whether the intangible asset is depreciable notwithstanding the closeness of that relationship.¹⁸⁹

Going back to *Red Wing Malting*,¹⁹⁰ the Court observed that the historical rationale for prohibiting depreciation deductions for goodwill was that it did not “suffer wear and tear.”¹⁹¹ Regulatory authority, on the other hand, authorized depreciation for measurably “wasting” intangible assets.¹⁹² Therefore, the dispositive characteris-

183. Justices Blackmun, Stevens, O’Connor, Kennedy, and Thomas comprised the majority; with Chief Justice Rehnquist and Justices Souter, White, and Scalia dissenting. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1671-72 (1993).

184. *Id.* at 1681 (“[W]e now hold that a taxpayer able to prove that a particular asset can be valued and that it has a limited useful life may depreciate its value over its useful life regardless of how much the asset appears to reflect the expectancy of continued patronage . . .”).

185. *Id.* at 1675 (citing *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962)).

186. *Id.*

187. *Id.* at 1675-76. The Court makes the observation that any business’ intangible assets are related to fostering future customer patronage. *Id.* at 1673-76. Consequently, to a certain extent all intangibles fall under the broad umbrella of goodwill. *Id.* at 1676 n.9.

188. *Newark Morning Ledger*, 113 S. Ct. at 1676.

189. *Id.* The Court further noted: “We emphasize that while the ‘expectancy of continued patronage’ is a serviceable description of what we generally mean when we describe an intangible asset that has no useful life and no ascertainable value, this shibboleth tells us nothing about whether the asset in question is depreciable.” *Id.* at n.9.

190. *Red Wing Malting Co. v. Willcuts*, 15 F.2d 626 (1926), *cert. denied*, 273 U.S. 763, (1927).

191. *Newark Morning Ledger*, 113 S. Ct. at 1676 (referring inferentially to I.R.C. § 167 and accompanying Regulation § 1.167(a)-3).

192. *Id.* at 1680 (citing *Red Wing Malting*, 15 F.2d at 633). In a 1968 Revenue Ruling, the IRS stated that the original costs of dredging during the construction of a pier were not depreciable, but the periodic re-dredgings were depreciable intangible

tic for depreciation was the notion of limited life.¹⁹³ Whenever a taxpayer met the factual burden of proving with reasonable accuracy that the value of an intangible asset diminished over an ascertainable period of time, it logically followed that depreciation deductions were permissible.¹⁹⁴ This allowance was valid regardless of the proximal relationship between the intangible asset and the "expectancy of continued patronage."¹⁹⁵

In addition, the Court reaffirmed the mass-asset rule's vitality in response to the Third Circuit's observation that it was "outdated."¹⁹⁶ As with goodwill, the mass-asset rule had been used to deny depreciation for those intangibles that, although fluctuating, did not diminish.¹⁹⁷ The Court adopted the district court's finding that "paid

assets. Rev. Rul. 68-483, 1968-2 C.B. 91. According to the Service, the litmus test for whether an intangible was depreciable depended on "the determination that the asset is actually exhausting, and that such exhaustion is susceptible of measurement." *Id.* at 91-92. This ruling was later modified to the extent that costs for excavating and dredging were characterized as tangible property, not intangible. Rev. Rul. 75-137, 1975-1 C.B. 74. The depreciation litmus test itself remained unchanged. *Id.*

193. *Newark Morning Ledger*, 113 S. Ct. at 1680-81.

194. *Id.* at 1680.

195. *Id.* at 1680-81. The Court observed: "The entire justification for refusing to permit the depreciation of goodwill evaporates, however, when the taxpayer demonstrates that the asset in question wastes over an ascertainable period of time." *Id.* at 1680. Further clarifying its position, the Court stated: "The significant question for purposes of depreciation is not whether the asset falls 'within the core of the concept of goodwill,' . . . but whether the asset is capable of being valued and whether that value diminishes over time." *Id.* at 1681 (citation omitted). Making a related observation, the GAO, in a report on potential solutions to the intangible conundrum, stated that allowing depreciation deductions was a valid solution because "[t]his policy would be in accordance with the financial accounting standard that recognizes the value of all purchased intangible assets, including goodwill, that are consumed over time and, thereby, contributed to a business' ability to generate revenue." GAO/GGD-91-88, *supra* note 62, at 33.

196. *Newark Morning Ledger*, 113 S. Ct. at 1677. According to the Supreme Court, the Third Circuit read *Houston Chronicle* as the death knell for the mass-asset rule. *Id.* Confronting this erroneous notion directly, the Court confirmed that the mass-asset rule continued to "guide the decisions of the Tax Court with respect to certain intangible assets." *Id.* As an example, in *Ithaca Indus. v. Commissioner*, the Tax Court prohibited depreciation allowances for the value of a trained work force over the length of time each employee stayed with the company on the rationale that while the number of employees fluctuated, one employee's leaving did not "interrupt or destroy the continued existence of the whole." *Ithaca Indus. v. Commissioner*, 17 F.3d 684 (4th Cir. 1994), *aff'g* 97 T.C. 253, 267 (1991). The asset changed in character, but never actually diminished because each employee was only one component of the "assembled work force." *Newark Morning Ledger*, 113 S. Ct. at 1676-78 (citing *Ithaca Indus.*, 97 T.C. at 271).

197. *Newark Morning Ledger*, 113 S. Ct. at 1676; *see Golden State Towel*, 373 F.2d at 938 (holding customer list a non-depreciable mass-asset). In *Golden State Towel*, the Court of Claims made an explicit link between goodwill and the mass-asset principle, stating:

subscribers" were not self-regenerating, but wasted over an ascertainable period of time.¹⁹⁸ Morning Ledger had satisfactorily shown that "paid subscribers" was a finite set of subscriptions that diminished in value over a reasonably quantifiable time period.¹⁹⁹ In so ruling, the Court clarified the mass-asset principle in a manner consistent with its reading of the *Houston Chronicle* test.²⁰⁰

V. Internal Revenue Code Section 197

Soon after the *Newark Morning Ledger* decision, Congress enacted Code Section 197,²⁰¹ which addressed the depreciation-of-intangibles issue directly.²⁰² During the 1980s the scope of the intangible controversy grew to distressing proportions.²⁰³ According to a 1991

"[A] purchased terminable-at-will type of customer list is an indivisible business property with an indefinite, nondepreciable life, indistinguishable from—and the principal element of—goodwill, whose ultimate value lies in the expectancy of continued patronage through public acceptance." *Id.* at 944.

198. *Newark Morning Ledger*, 113 S. Ct. at 1681, 1683. The majority conceded that the district court would have had more difficulty deciding the case if the Service's trial strategy had involved challenging the evidence presented by Ledger's experts. *Id.* at 1681. However, the Service chose not to attack the accuracy of Ledger's estimations, but instead focused on methodology. *Id.* at 1683. "[T]he Government chose . . . to rest its entire case on a legal argument that we now reject. This case was lost at trial." *Id.* at 1682 n.14.

199. *Id.* at 1681. The opinion recognized that the dissent predominantly questioned whether Morning Ledger met its burden of proof concerning the "wasting" aspect of "paid subscribers." *Id.* at 1681-82, n.14 (citing dissenting opinion at 1686-89).

200. *Id.* at 1676-77. The Court stated: "Although there may have been some doubt prior to 1973 as to whether the mass-asset rule required that any asset related to the expectancy of continued patronage always be treated as nondepreciable goodwill as a matter of law, that doubt was put to rest by . . . the *Houston Chronicle* case." *Id.* As further clarification, the Court discussed *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446 (Ct. Cl. 1976). *Id.* at 1678. There, the Court of Claims had permitted deductions for purchased insurance expirations, which it viewed as a "mass-asset." The court reasoned that the mass-asset rule did not mandate disallowance of depreciation deductions when "the expirations as a single asset can be valued separately and the requisite showing made that the useful life of the information contained in the intangible asset as a whole is of limited duration." *Richard S. Miller*, 537 F.2d at 452. See Reuven S. Avi-Yonah, *Newark Morning Ledger: A Post-Litem and Some Implications*, 59 TAX NOTES 813, 815-16 (1993) (noting that the Supreme Court majority in *Newark Morning Ledger* essentially emasculated the mass-asset rule with its reasoning).

201. The *Newark Morning Ledger* decision came down on April 20, 1993, while Code Section 197's enactment date was August 10, 1993—a time lapse of less than four months.

202. I.R.C. § 197. Pursuant to the new Section, "A taxpayer shall be entitled to an amortization deduction with respect to any amortizable Section 197 intangible." I.R.C. § 197(a).

203. The General Accounting Office noted that during 1989 there were 2,166 open audit issues related to taxpayer-claimed depreciation deductions challenged by the Service. GAO/GGD-91-88, *supra* note 62, at 22. The taxpayer value attached to the

General Accounting Office report, solicited by the Joint Committee on Taxation, the value of intangible assets linked to business acquisitions reached \$262 billion in 1987.²⁰⁴ The report recognized that concomitant to this astoundingly large sum of money were the potential deductions and tax revenues at stake.²⁰⁵ Of those cases examined for the study (exclusively purchased-intangible-asset controversies)²⁰⁶ roughly seventy percent involved deduction denials because the IRS argued that the assets were "in fact goodwill and not amortizable."²⁰⁷

The GAO report noted three possible alternatives for addressing the depreciation problem. First, depreciation of intangible assets could be expanded to include those that wasted over time, sometimes including goodwill.²⁰⁸ Second, depreciation could be disallowed altogether for specific purchased intangible assets or categories of intangible assets by categorizing them to have indeterminable useful lives as a matter of law.²⁰⁹ Third, the current situation could be allowed to continue without revision to the tax rules.²¹⁰ The GAO recommended that Congress revise the current tax law to allow depreciation deductions of a purchased intangible asset according to a specific statutory cost recovery period,²¹¹ similar to the treatment of tangible assets.²¹² This revision, it recommended, should include goodwill.²¹³

Congress enacted Code Section 197²¹⁴ as part of the Omnibus Budget Reconciliation Act of 1993.²¹⁵ The new provision provides

intangibles in controversy totaled over \$23 billion. *Id.*

204. UNITED STATES GENERAL ACCOUNTING OFFICE, GAO/GGD-91-88, *Tax Policy: Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets*, 10 (August 1991) (attributing this rise, in part, to the brisk business acquisition activity during the 1980s).

205. *Id.* at 2.

206. The GAO noted that its analysis was based on data gathered by the IRS from all pending cases involving purchased intangible assets. *Id.* at 3 (noting that the cases generally involved the tax years 1979 to 1987).

207. *Id.* at 21. The report recognized the bases for this high percentage by stating: "The vague definition of goodwill, as well as taxpayers' latitude in determining useful life, has led to frequent disputes between taxpayers and IRS." *Id.*

208. GAO/GGD-91-88, *supra* note 204 at 32 (citing then legislative proposals H.R. 1456, H.R. 3035, and S. 1245 as generally advocating this proposition).

209. *Id.* (citing then legislative proposal H.R. 563 as generally advocating this position).

210. *Id.*

211. *Id.* at 6.

212. *Id.* at 33.

213. GAO/GGD-91-88, *supra* note 204 at 6.

214. See Brode, *supra* note 14, at 1012 n.2 (providing synopsis of the legislative history); Bennett Minton and Lee A. Sheppard, *An Intangible Quandary: To Which Taxpayers Go the Spoils?*, 55 TAX NOTES 1568 (1992) (providing legislative history for the bill providing depreciation for intangibles).

215. Pub. L. No. 103-66, 107 Stat. 270 (1993); see Douglass, *supra* note 50, at 726-62 (providing a thorough explanation and analysis of Section 197).

for a fifteen-year depreciation period for those acquired intangibles that come within its scope.²¹⁶ A "Section 197 intangible" is generally defined as any Section 197 intangible (1) acquired after August 10, 1993,²¹⁷ and (2) held in connection with a trade or business²¹⁸ or an activity described in Section 212.²¹⁹ Following this general proposition, Section 197 includes a "laundry list"²²⁰ of specific

216. I.R.C. § 197(a). The general rule states:

A taxpayer shall be entitled to an amortization deduction with respect to any amortization Section 197 intangible. The amount of such deduction shall be determined by amortizing the adjusted basis (for purposes of determining gain) of such intangible ratably over the 15-year period beginning with the month in which such intangible was acquired.

Id. Section 197 applies generally to Section 197 intangibles acquired under a Section 338 stock purchase asset acquisition. H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 688-89 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1377-78. Section 197 generally does not apply if the intangible is created by the taxpayer or if the intangible is not created in connection with a transaction or series of related transactions involving acquisition of a trade or business or a substantial portion thereof. *Id.*

217. I.R.C. § 197(c)(1)(A) ("[T]he term 'amortizable Section 197 intangible' means any Section 197 intangible . . . which is acquired by the taxpayer after the date of the enactment of this section . . .").

218. I.R.C. § 197(c)(1)(B). Determination of whether acquired assets constitute a substantial portion of a trade or business is to be based on all of the facts and circumstances, including the nature and the amount of the assets acquired as well as the nature and amount of the assets retained by the transferor. H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 678 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1367. However this comparison is not determinative. *Id.* A group of assets is to constitute a trade or business if the use of such assets would constitute a trade or business for the purpose of § 1060 (special allocation rules for certain asset acquisitions), i.e., if the assets are of such a character that goodwill or going concern value could under any circumstances attach to the assets. *Id.* In addition, the acquisition of a franchise, trademark or trade name is to constitute the acquisition of a trade or business or substantial portion thereof. *Id.*

219. I.R.C. § 197(c)(1)(B). Code § 212 concerns expenses for the production of income. I.R.C. § 212.

220. I.R.C. § 197(d)(1). This is a modification on the GAO's suggestion of assigning specific recovery periods to the various intangible assets at issue. GAO/GGD-91-88, *supra* note 62, at 33. The blanket 15-year depreciation schedule ultimately adopted was likely an attempt at satisfying the two stated goals of enacting the section: (1) eliminate depreciation-related controversies for intangible assets; and (2) simplify the law regarding depreciation of intangible assets. Douglass, *supra* note 50, at 753 (citing first, *Tax Treatment of Intangible Assets: Hearings Before the Committee on Ways and Means House of Representatives*, 102d Cong., 1st Sess. 44 (1991) at 22 (statement of Chairman Rostenkowski) (remaining citations omitted)). Martin Gregorich proved prescient when in 1975 he wrote: "The dichotomy between amortizable and non-amortizable intangibles thus is called into question. A presumption as to the limited usefulness of all purchased competitive advantages, coupled with guideline lives (unless the taxpayer can prove a shorter life) is on the horizon." GREGORICH, *supra* note 4, at 271.

intangibles that are "Section 197 intangibles."²²¹ That list includes goodwill.²²²

Section 197 applies generally to "Section 197 intangibles" acquired under Section 338 acquisitions.²²³ Sections 338(b)(5) and 1060 provide for purchase price allocation among assets in the case of certain acquisitions. Under regulations promulgated pursuant to that authority, the purchase price of an acquired trade or business must be allocated among the assets of the trade or business using the "residual method."²²⁴ Section 1060 authorizes the Treasury Department to

221. I.R.C. § 197(d)(1).

222. I.R.C. § 197(d)(1)(a). Under Section 197, goodwill is "the value of a trade or business that is attributable to the expectancy of continued customer patronage, whether due to the name of a trade or business, the reputation of a trade or business, or any other factor." H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 674 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1363.

223. H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 688-89 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1377-78. It is interesting to note that the Conferees directed the Treasury Department to conduct a continuing study of the implementation and effects of Section 197, including effects on merger and acquisition activity (including hostile takeovers and leveraged buyouts). *Id.* at 690, 1993 U.S.C.C.A.N. at 1379. The first to be due no later than Dec. 31, 1994, then annually thereafter. *Id.* (As of this writing no report has been made available.) The Wall Street Journal reported that merger and acquisition activity for the third quarter of 1994 was at its highest level since the Merger and Acquisition ("M&A") boom of the 1980s. Greg Steinmetz, *Mergers and Acquisitions Ran At Record Pace in Third Quarter*, WALL ST. J., Sept. 30, 1994, at C1; *see also* Greg Steinmetz, *Salomon Tops M&A Listing For 9 Months*, WALL ST. J., Oct. 5, 1994, at C1 (noting that during the first nine months of 1994 "every merger-and-acquisition shop was living large"). While many factors likely provided impetus for this trend, such as favorable interest rates, it is likely that the *Newark Morning Ledger* decision, along with enactment of Section 197, were favorable factors in the decision-making of recent corporate "raiders." *See* Persellin, *supra* note 91, at 211 (observing that the *Newark Morning Ledger* decision benefits those participating in business acquisitions).

224. Treas. Reg. §§ 1.338, 1.1060-IT. Under the residual method, all assets of an acquired trade or business are divided into the following classes: (1) Class I assets generally include cash and cash equivalents; (2) Class II assets generally include certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency; (3) Class III assets include all assets other than those included in Class I, II, or IV (generally all furniture, fixtures, land, buildings, equipment, other tangible property, accounts receivable, covenants not to compete, and other depreciable intangible assets); (4) Class IV assets include intangible assets in the nature of goodwill or going concern value. H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 689 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1378. The purchase price of an acquired trade or business (as first reduced by amount of Class I assets) is allocated to the assets included in Class II and Class III based on the value of assets included in each class. *Id.* To the extent that the purchase price (as reduced by the amount of the assets in Class I) exceeds the value of the assets included in Class II and Class III, the excess is allocable to assets included in Class IV. *Id.* According to the House of Representatives report: "It is anticipated that the residual method specified in the regulations will be modified to treat all amortizable Section 197 intangibles as Class IV assets and that this modification will apply to any acquisition of property to which the

require the transferor and transferee, in certain asset acquisitions, to furnish information to the Treasury Department concerning the amount of any purchase price allocated to goodwill or going-concern value.²²⁵ Information furnished with respect to certain asset acquisitions is to specify the amount of purchase price allocated to depreciable "Section 197 intangibles" rather than the amount of purchase price allocated to goodwill or going-concern value.²²⁶ Additionally, taxpayers are required to furnish the amount of purchase price allocated to intangible assets that are not depreciable Section 197 intangibles.²²⁷ The Conference Report stated explicitly that "[n]o other depreciation or amortization deduction is allowed with respect to a Section 197 intangible that is acquired by a taxpayer."²²⁸

VI. Analysis

A. *Relevance of Newark Morning Ledger* Prior to Section 197

The Supreme Court's rejection of the substantivist test in *Newark Morning Ledger* was a taxpayer victory.²²⁹ Among the benefits emanating from the decision were favorable treatment of acquired intangible assets and greater certainty in the tax system.²³⁰ By resolving the conflict between disparate judicial methods, *Newark Morning Ledger* provided: (1) precedent for the depreciation of acquired customer-based assets; and (2) a uniform test for the depreciation of intangible assets.

bill applies." H.R. REP. NO. 2141, 103d Cong., 1st Sess. 689 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1378.

225. I.R.C. § 1060(b)(1) ("Under regulations, the transferor and transferee in an applicable asset acquisition shall . . . furnish to the Secretary . . . (1) The amount of the consideration received for the assets which is allocated to goodwill or going concern value.").

226. H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 689 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1378. *But see* I.R.C. § 1060(b)(1).

227. I.R.C. § 1060(b)(3); *see* H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 689 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1378.

228. H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 673 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1362.

229. *But see* George L. Middleton Jr. & Christian M. McBurney, *The Morning After Newark Morning Ledger: What Should Taxpayers Do Now?* 59 TAX NOTES 817, 828 (1993) (criticizing the facts-and-circumstances test as bad tax policy).

230. The Court's decision may also have motivated Congress to pass the new Code Section 197 dealing with the depreciation of goodwill and other intangibles. The urgency may have heightened so as to avoid exacerbating the significant pending problems regarding intangibles litigation. *See* Middleton, *supra* note 229, at 826 (suggesting that *Newark Morning Ledger* may spur congressional interest in passage of a bill providing depreciation for intangibles).

First, to fairly distribute the tax burden, the method of calculating gross income must be accurate.²³¹ To accomplish this end, the Code generally seeks to match income and expenses in the taxable year to which they are properly attributable.²³² The Supreme Court implicitly recognized that the regulatory foundation for depreciation deductions was, in part, this "matching" principle.²³³ Denying depreciation deductions for the decline in value of an intangible asset that the taxpayer proved had a limited useful life is inconsistent with tax theory that seeks to tax net income.²³⁴ According to the Court, this denial of depreciation deductions remained true regardless of how closely related in appearance an intangible was to the expectancy of continued patronage.²³⁵

231. See, e.g., *INDOPCO, Inc. v. Commissioner*, 112 S. Ct. 1039, 1043 (1992) ("[T]he Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes.").

232. *Id.*

233. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1680 (1993) ("[W]hen the taxpayer demonstrates that the asset in question wastes over an ascertainable period of time. . . . [i]t is more faithful to the purposes of the Code to allow the depreciation deduction . . .").

234. Net income is the difference between gross income and the cost of producing that income. *BLACK'S LAW DICTIONARY* 1040 (6th ed. 1990). Under the Haig-Simons theory, economic income in its broadest sense is "accretion," that is the change in value of property rights. See Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 *TAX L. REV.* 1, 7-8 (1992). Consequently, it would be inconsistent to deny a taxpayer an offset to taxable income for the wasting value of an asset.

235. *Contra* Johnson, *supra* note 167, at 629. Johnson argues that permitting deductions for customer-based intangibles, particularly those that are replenished with tax-deductible expenditures, distorts income measurement. *Id.* at 631-32, 634. Advocating the "glory" of the mass asset rule, Johnson notes that Morning Ledger's subscriber base taken as a whole did not exhaust or depreciate, despite the attrition of individual subscribers, because new subscribers were added. *Id.* at 631. When an asset's value is maintained with expensed costs there is no diminishing capital worthy of depreciation deductions. *Id.* "Under the mass asset rule of accounting, a taxpayer's cost of acquiring a subscription base or similar intangible is to allow deduction of the costs of replenishing or replacing the base, but to capitalize the initial cost of the base without amortization." *Id.* at 631-32.

The argument becomes less convincing when a comparison is made between acquired tangible assets and acquired intangible assets. The tax treatment for both categories of assets sacrifices perfect congruity with economic reality in order to achieve other important policy ends. For example, the accelerated cost recovery system (ACRS) dislocates depreciation from an acquired tangible asset's true "wasting" nature, but fulfills its simplifying purpose. Accepting this inconsistency, why should greater allegiance to economic reality be forced on acquired intangibles at the expense of simplicity? To be certain, "two wrongs don't make a right," but Johnson's proposition would effect an unwarranted and undesirable tax preference for tangible assets over intangible assets. In its decision, the Supreme Court made no distinction between the

Second, vague definitions have no place in modern tax law. By establishing a uniform test for depreciation, *Newark Morning Ledger* provided much awaited certainty to identifying depreciable intangible assets. As noted by the Court, defining goodwill as "expectancy," while convenient, was irrelevant, did not address the problems of the federal tax laws, and was of no analytical use in the present case.²³⁶ It was this vague definition of goodwill, along with the conflicting tests, that vexed taxpayers and fueled the litigation fire.²³⁷ The Supreme Court's reasoning demonstrated that although non-depreciable goodwill might be the elusive concept of "continued patronage," depreciable intangibles could be carved out of "goodwill" when shown to have ascertainable values and limited useful lives.²³⁸ While the decision was by no means a cure-all, it was a significant step in the direction of bringing consistency to a troubled area of tax law.

B. *Relevance of Newark Morning Ledger After Section 197*

With the enactment of Code Section 197, questions arise concerning what purpose, if any, *Newark Morning Ledger* now serves in tax planning and controversies. At first glance it might appear that the dramatic addition of Section 197 to the Code mooted this hard-fought taxpayer victory. Now goodwill, along with other "controversial" intangible assets, is expressly depreciable under the Code. Despite this change, any rumor of the decision's precedential "death" are greatly exaggerated.²³⁹ *Newark Morning Ledger* continues to play a significant, albeit smaller, role in tax law as controlling precedent with respect to three

depreciation of tangibles and intangibles based on how related, post-acquisition expenditures were treated. *Newark Morning Ledger*, 113 S. Ct. at 1680. Instead, the Court confirmed that the fundamental rationale for depreciating "any asset" was that it wasted over an ascertainable period of time. *Id.* at 1680-81.

236. *Newark Morning Ledger*, 113 S. Ct. at 1675-76.

237. See GAO/GGD-91-88, *supra* note 62, at 20. The GAO observed:

The vague definition of goodwill, as well as taxpayers' latitude in determining useful life, has led to frequent disputes between taxpayers and IRS. Some of these disagreements have been resolved in the courts, where the decisions have been influenced by the most convincing evidence. This situation has resulted in inconsistent treatment of similarly situated taxpayers.

Id.

238. *Donrey*, 809 F.2d at 536-37; see also *Newark Morning Ledger*, 945 F.2d at 563 (recognizing the *Donrey* court's implicit adoption of the residual definition of goodwill). A concomitant benefit to the residualist test, as opposed to the substantivist definition, is its fluidity. In other words, the residualist approach will apply consistently to future intangible assets that have yet to be identified. *Id.* at 563-64.

239. It was Mark Twain who cabled the Associated Press from Europe, quipping: "The report of my death was an exaggeration."

important issues concerning both Section 197²⁴⁰ and non-Section 197 intangible²⁴¹ assets: (1) valuation issues, (2) duration issues, and (3) characterization issues.

1. Valuation Issues

The *Newark Morning Ledger* decision affirmed the “facts and circumstances”²⁴² approach to intangible asset valuation. The Court recognized that the taxpayer’s burden of proof to establish value “often will prove too great to bear,”²⁴³ but is nonetheless viable. As required by the Code, the purchase price of an acquired business must be allocated across all the purchased assets using the residual method.²⁴⁴ Thus, the incentive remains for the taxpayer to allocate as much of the purchase price to those assets with the shortest recovery period.²⁴⁵ If the IRS challenges the amount that a taxpayer allocated to “Section 197 goodwill,” the taxpayer may use the holding of *Newark Morning Ledger* to prove its claimed allocation with sufficient evidence. These value-allocation issues arise in both inter-class²⁴⁶ and intra-class²⁴⁷ purchase price allocations pursuant to Code Section 1060.²⁴⁸

240. I.R.C. § 197(d) (designating specific Section 197 intangibles). A taxpayer has the option of retroactive application of Section 197 to acquisitions made between July 26, 1991, and August 10, 1993 (the enactment date of Section 197). H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 691 (1993), *reprinted* in 1993 U.S.C.A.N. 1088, 1380. See MARTIN D. GINSBURG & JACK S. LEVIN, *MERGERS, ACQUISITIONS AND LEVERAGED BUYOUTS* ¶ 403.0446 (1994) (providing further discussion of effective dates and taxpayer electives).

241. Section 197 excludes pre-Section 197 intangibles (those acquired prior to August 10, 1993), as well as a number of intangible assets listed in § 197(e), such as: (1) interests in corporations, partnerships, trusts and estates, (2) financial interests in contracts, (3) interests in land, (4) certain interests in computer software, (5) interests in separately acquired films, sound recordings, video tape, books or the like, (6) interests in separately acquired governmental or contract rights to tangible property or services, (7) interests in separately acquired patents or copyrights, (8) interests under leases, (9) interests in indebtedness, (10) sports franchises, (11) interests in separately acquired mortgage servicing rights, and (12) certain transaction costs. I.R.C. § 197(a), (e).

242. See *supra* notes 184-187 and accompanying text.

243. *Newark Morning Ledger*, 113 S. Ct. at 1681.

244. I.R.C. §§ 338, 1060.

245. See Coff & Flamholtz, *supra* note 15, at 37 (“In its current form, this bill would create incentives to allocate the purchase price to equipment and other assets with a useful life of less than fourteen years and might actually provide a disincentive for acquiring land and buildings which have longer useful lives.”).

246. Inter-class allocation of purchase price, pursuant to Code § 1060, refers to allocations between assets of different classes.

247. Intra-class allocation refers to purchase price allocation, pursuant to Code § 1060, to assets falling within one of the four designated classes.

248. See *supra* notes 218-223 and accompanying text.

First, the issue of asset valuation remains unsettled for allocations between classes of assets in a business acquisition. For example, purchaser R acquires target business T and allocates the purchase price across all classes of acquired assets consistent with provisions of the Code and Regulations.²⁴⁹ The IRS denies R's depreciation deduction amounts claiming that R over-valued non-Section 197 assets with shorter depreciation periods and under-valued Section 197 intangibles. In response, R presents its expert's assessments and other evidence to factually support its valuation contentions. The persuasiveness of R's argument must be considered against the substantial burden of proof that accompanies the "facts and circumstances" method of valuing intangible property.

Second, valuation issues also remain in allocations within the class of Section 197 intangibles.²⁵⁰ While the depreciation allowance of previously non-depreciable intangible assets is clearly favorable for most taxpayers, the imposition of a mandatory fifteen-year depreciation schedule is not.²⁵¹ The rationale for this flat rate was tax revenue balancing,²⁵² that is, the tax revenues lost by permitting depreciation deductions for goodwill were made up by stretching out the shorter depreciation periods for other Section 197 intangibles.

For example, while the value of acquired goodwill can now be depreciated under Section 197, the value of all non-compete covenants acquired in a purchase are subject to the same fifteen-year schedule²⁵³ regardless of their actual duration (typically less than fifteen years). Although extended depreciation periods for assets with factually shorter lives is unfavorable for taxpayers, there are tax planning opportunities that can work to the advantage of taxpayers in certain types of acquisitions.²⁵⁴ The after-effects of Section 197's

249. See *supra* note 224.

250. According to the House of Representatives report: "It is anticipated that the residual method specified in the regulations will be modified to treat all amortizable Section 197 intangibles as Class IV assets and that this modification will apply to any acquisition of property to which the bill applies." H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 689 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1378.

251. See *supra* note 13 and accompanying text. See generally GINSBURG & LEVIN *supra* note 240, ¶ 403.044-0447 (1994) (discussing the impact of Code Section 197).

252. Kevin M. Helmich, *The Amortization of Intangible Assets: An Analysis of H.R. 3035 Proposed by House Ways and Means Committee Chairman Dan Rostenkowski*, 55 TAX NOTES 987, 989-90 (1992) (noting that House Ways and Means Committee Chairman Dan Rostenkowski wanted to make the effect of the new Code section as revenue neutral as possible).

253. I.R.C. § 197(d)(1)(E).

254. See GINSBURG & LEVIN, *supra* note 240, at ¶ 403.0445 (1994). The blanket treatment of Section 197 intangibles calls for new tax planning considerations, particularly for taxpayers acquiring businesses where goodwill constitutes a significant portion of the purchase price. *Id.* Under pre-Section 197 law, taxpayers allocated as

blanket fifteen-year depreciation period, however, are some of the very same revenue-to-expense distortions that taxpayers, like Newark Morning Ledger, sought to rectify. In other words, Section 197's enactment neither produced an incentive to accurately value intangibles within a class of assets, nor substantially furthered change towards greater accuracy in the matching of expenses and deductions.

Consequently, Section 197's fifteen-year depreciation period has a twofold impact: (1) it fails to shed light on resolving purchase price allocation controversies between Section 197 and non-Section 197 assets;²⁵⁵ and (2) it treats the class of Section 197 intangibles identically without consideration of the actual revenue-to-expense effect on any one taxpayer. Essentially, purchase price allocations between classes of assets in business acquisitions remain status quo due to the ubiquitous monetary incentives of shorter depreciation periods.²⁵⁶ In addition, although Section 197 eliminates some of the monetary incentive to contest reasonable allocations between Section 197 intangibles, potential tax planning benefits will continue to be a consideration for buyers and sellers on intra-class allocations.²⁵⁷

much purchase-price value to non-compete clauses, as opposed to goodwill, because of the shorter depreciation schedule. *Id.* Now, under Section 197, a taxpayer might actually benefit from allocating purchase price to goodwill rather than a non-compete covenant because: (1) the seller's gain on the sale of goodwill is generally capital gain, while a non-compete covenant is treated as ordinary income; and (2) goodwill has a less adverse impact on generally accepted accounting principles ("GAAP") earnings in the early years after acquisition because GAAP permits amortization of goodwill over forty years, while a non-compete covenant is more short-lived. *Id.*

255. See Douglass, *supra* note 50, at 727 (noting that disagreements should be minimized).

256. As noted by commentator George Brode Jr.:

In essence, by casting aside prior law and treating nearly every intangible as a "Section 197 intangible" required to be written off over a 15-year period, the roles of the Internal Revenue Service and taxpayers now may be reversed. Thus, for example, the Internal Revenue Service now may insist that a greater portion of the acquisition price should be allocated to a "Section 197 intangible" required to be written off over a 15-year period, while the taxpayer might argue that the purchase price more properly is allocable to certain tangible assets that may be written off over a shorter useful life. Since the taxpayer has the opportunity to structure the form of the transaction, careful attention should be paid to identifying tangible assets having a useful life of less than 15 years and securing fair market value appraisals that support taxpayers' allocation of the purchase price over the tangible and intangible assets acquired.

Brode, *supra* note 14, at 1019-20; see Helmich, *supra* note 14, at 991 (observing that determining the true value of tangible property is much easier than valuing intangibles, thereby making misallocation-application controversies rare).

257. See GINSBURG & LEVIN, *supra* note 240.

2. Duration Issues

By affirming the two-pronged *Houston Chronicle* test,²⁵⁸ *Newark Morning Ledger* remains controlling precedent for the “facts and circumstances” approach²⁵⁹ of establishing an intangible asset’s useful life. An intangible asset falling outside Section 197 potentially has a duration-of-useful-life issue if it has a diminishing value. Since taxpayers will continue to seek the shortest depreciation period possible, the Service’s challenges to these estimates remain valid controversies. The enactment of Section 197 eliminates the controversies for traditionally contentious intangibles, like customer-based assets, by permitting depreciation over fifteen years.²⁶⁰ In the realm of intangibles falling outside the scope of Section 197, however, useful-life issues remain open to argument.

For example, in a pre-Section 197 acquisition purchaser R acquires target business T. As part of the deal, R now owns a trained work force. In its purchase-price allocation, R seeks to depreciate the value allocated to the work force over the average length of time the employees remain with the company. The Service disallows the deduction stating that the useful life of the asset is not reasonably ascertainable. Pursuant to *Newark Morning Ledger*, taxpayer R presents its evidence (for example, expert testimony and statistical studies) to meet its burden of establishing a limited useful life for the assembled work force asset.²⁶¹ The trier of fact then decides whether R’s burden of proof was met. In sum, while Section 197 enveloped a large segment of the universe of intangible assets, duration issues remain, particularly for pre-Section 197 intangibles caught in the backlog of pending IRS controversies.²⁶²

258. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1683 (1993) (providing that a taxpayer must prove an intangible asset possesses “an ascertainable value and a limited useful life, the duration of which can be ascertained with reasonable accuracy”).

259. See *supra* notes 184-187 and accompanying text.

260. I.R.C. § 197(d).

261. A very similar scenario was resolved by the United States Tax Court against the taxpayer in *Ithaca Indus. v. Commissioner*, 97 T.C. 253 (1991), *aff’d*, 17 F.3d 684 (4th Cir. 1994). In that case, a clothing manufacturer sought to depreciate \$7.7 million for the asset “assembled work force” of the acquired company. *Ithaca*, 17 F.3d at 686. The Tax Court denied the deduction based on *Ithaca*’s failure to prove that the asset’s value diminished over time or through use. *Ithaca*, 97 T.C. at 267. This decision has been criticized on the basis that its analysis is reminiscent of the mass asset rule’s denial of depreciation for assets whose values “merely ebb and flow.” See GINSBURG & LEVIN, *supra* note 240, ¶ 403.045 (1994); Helmich, *supra* note 14, at 988-89.

262. Pursuant to Congressional urgings, the IRS offered a settlement initiative on February 9, 1994, to taxpayers in pending intangible controversies. H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 690 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1379.

3. Characterization Issues

Goodwill remains undefined by the Code and Regulations. The Conference Report to Section 197, however, defined goodwill as the value of a trade or business that is attributable to the expectancy of continued customer patronage.²⁶³ It is uncertain what this means to the characterization debate. If this statement means that Congress is now adopting the substantivist approach to goodwill, then the practical effect is that all intangible assets not specifically excluded from Section 197, yet resembling customer patronage, are swallowed up in this broad definition and are depreciated over fifteen years.²⁶⁴ If instead the definition is merely an acknowledgment of the long-standing conceptual term-of-art, then the residualist approach of *Newark Morning Ledger* remains a valuable planning and litigation tool with respect to non-Section 197 assets as it may be used to differentiate an intangible from Section 197 goodwill. It remains to be seen how the definitional question will be resolved.²⁶⁵

Under the program, the taxpayer could elect to settle its case by accepting a reduction in the amount of depreciable intangibles claimed by 15 percent or by an amount sufficient to yield a 50 percent cost recovery for the intangible. See *IRS Briefing Materials*, reprinted in TAX NOTES TODAY (Feb. 9, 1994) (LEXIS, FEDTAX, TNT file, elec. cit. 94 TNT 30-8). The Conference Report contained the following statement: "[N]o inference is intended that any deduction should be allowed in these cases for assets that are not amortizable under present law." H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 690 (1993), reprinted in 1993 U.S.C.C.A.N. 1088, 1379. The practical effect of this statement was to exclude goodwill from the settlement program. Consequently, using the "facts and circumstances" argument in *Newark Morning Ledger*, a taxpayer who believes that they have a strong factual position might reject the settlement and pursue litigation. See generally Jones & Rood, *supra* note 16, at 196 (evaluating the Service's offer).

263. H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 674 (1993), reprinted in 1993 U.S.C.C.A.N. 1088, 1363.

264. The House Report expected that Section 197 would encompass all Class IV intangibles, providing evidence for the substantivist notion of goodwill. In particular, the House Report stated: "It is anticipated that the residual method specified in the regulations will be modified to treat all amortizable Section 197 intangibles as Class IV assets and that this modification will apply to any acquisition of property to which the bill applies." H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 689 (1993), reprinted in 1993 U.S.C.C.A.N. 1088, 1378. See Brode, *supra* note 14, at 1018 (noting that the House Report requires modification of the "residual method" to reflect the amortization of goodwill and going concern value).

265. Another related issue involves the interplay between *Newark Morning Ledger*, *INDOPCO, Inc. v. Commissioner*, 112 S. Ct. 1039 (1992), and Section 197. In *INDOPCO*, the Court held that banking fees, legal fees and transaction fees could not be expensed but must be capitalized because they created significant long-term benefits for the acquired entity. *INDOPCO*, 112 S. Ct. at 1045. See generally Lyke, *supra* note 91, at 1239 (analyzing the decision and its effects). The fundamental issue in *INDOPCO* was one of timing, since the expenses and fees would have been deductible either as

Characterization issues also arise in the context of Section 197's "anti-churning"²⁶⁶ rules. These rules exist to prevent abuse of the newly established deduction allowances²⁶⁷ and to affect the tax consequences of acquisitions when the acquiring taxpayer is related to the seller.²⁶⁸ The scope of the anti-churning provisions is limited to Section 197 intangibles that would not be depreciable without Section 197, which are essentially those intangible assets without a reasonably ascertainable useful life, such as goodwill.²⁶⁹

For example, characterization questions continue to exist for intangible assets, like customer lists, under the anti-churning rules. If the taxpayer cannot successfully distinguish the customer list from goodwill by meeting its evidentiary burden under *Newark Morning Ledger*, then the asset remains non-depreciable goodwill.²⁷⁰ On the other hand, if the taxpayer's burden is met, establishing that the customer list would have been depreciable under pre-Section 197 law,

expenses or amortized over the life of the underlying asset. *Id.* at 1239-40. In *Newark Morning Ledger*, the Court was presented with an all-or-nothing proposition. Since Section 197 was not yet enacted, if the Court had decided against distinguishing "paid subscribers" from goodwill, then \$68 million would have been identified as a non-depreciable asset.

As an illustration of the problem, consider interests in indebtedness. An interest in indebtedness, which is specifically excluded from Section 197 by Section 197(e)(5), is often a capitalized cost under Section 263 when it involves "[any] amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." I.R.C. § 263(a)(1).

Suppose that purchaser R acquires target business T and the transaction includes a two-year favorable financing option. How this option is treated has significant effects on the timing of R's cost recovery. If, for tax purposes, the option stands alone, then its value should be depreciable either over the two-year period or at its expiration. Alternatively, if the value of the option is capitalized into T's factory, then the cost recovery of the two-year option might be stretched out over the 39-year life of the factory. Finally, if the option is capitalized into T's goodwill, then it is recovered over the 15-year depreciation schedule of Section 197. It is likely that the Service will be paying close attention to how the value of underlying assets is cost-recovered so as to enhance revenue generation.

266. H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 691-93 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1380-82. The anti-churning rules are meant to curb abuse by preventing taxpayers from "converting existing goodwill, going concern value, or any other Section 197 intangible for which a depreciation or amortization deduction would have not been allowable under present law into amortizable property to which the bill applies." *Id.* at 691, U.S.C.C.A.N. at 1380.

267. I.R.C. § 197(f)(9).

268. I.R.C. § 197(f)(9)(C) (defining "related person").

269. I.R.C. § 197(f)(9)(A)-(B). See GINSBURG & LEVIN, *supra* note 240, ¶ 403.0444 (providing further discussion on Section 197's anti-churning rules).

270. GINSBURG & LEVIN, *supra* note 240, ¶ 403.0444.

then the anti-churning rules do not apply and Section 197's fifteen-year schedule takes effect.²⁷¹

Finally, it is certain that the persuasive power of *Newark Morning Ledger* remains viable for those taxpayers opting into the Service's settlement program for pending intangible controversies.²⁷² Congress strongly urged the IRS to settle as many of the two thousand pending intangible-related issues as possible.²⁷³ The report also noted that then-current law would apply to intangibles acquired prior to the enactment of Section 197.²⁷⁴ Since goodwill was not a depreciable asset at that time, the *Newark Morning Ledger* decision supports taxpayers possessing sufficient evidence to overcome the substantial burden of proof involved in distinguishing depreciable intangible assets from non-depreciable goodwill.

VII. Conclusion

The true nature of goodwill remains a nebulous concept in tax law. In *Newark Morning Ledger*, the Supreme Court brought much needed predictability to the muddled history of distinguishing depreciable intangible assets from goodwill. Although the decision eschewed any substantive definition of goodwill, it presented a consistent method for identifying goodwill in an effort to achieve sound tax policy. The subsequent enactment of Code Section 197 explicitly provided for the depreciation of the elusive goodwill concept, thereby curing a symptom of the disease that gave rise to the *Newark Morning Ledger* controversy.

The addition of Section 197 to the Code brings welcome relief from the burdensome expense associated with intangible-asset disputes, particularly with respect to goodwill. The fifteen-year depreciation period provided in Section 197, however, may be criticized on the basis that it only marginally reflects the true "wasting" nature of any one particular Section 197 intangible, thereby treating taxpayers from varying circumstances identically. While the provision will likely reduce the number of taxpayer protests, the Code change does not deal with the root of the problem: the need for a clear definition of

271. *Id.*

272. *See supra* note 262.

273. H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 690 (1993), *reprinted in* 1993 U.S.C.A.N. 1088, 1379.

274. *Id.*

goodwill. In the aftermath of Section 197, *Newark Morning Ledger* continues to provide precedential guidance to resolving valuation, duration, and characterization issues related to intangible assets falling both inside and outside the scope of Section 197.

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